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# The Relevance of Fresh Investment to the Characterization of Corporate Distributions and Adjustments

GLENN E. COVEN \*

## Introduction

In our commercially complex world, a desired financial result quite commonly can be achieved through a variety of routes. Too frequently, the federal income tax consequences of obtaining the result vary considerably depending upon the route chosen, a highly undesirable result. The imposition of unequal tax burdens on similarly situated taxpayers is unfair. Moreover, the potential for disparate treatment injects economically wasteful tax gamesmanship into relatively routine commercial activities.

In many instances, inconsistent tax burdens are the unavoidable consequences of the very effort to tax a complex economy. A taxing system, to be comprehensible, must categorize transactions. A transaction which by chance or design approaches a prescribed boundary may be taxed very differently from its mirror image approaching the same boundary from the other side. Many such anomalies within our taxing system, however, are entirely avoidable. For reasons of historical accident or excessive administrative zeal, alternative forms of economically identical transactions simply may have been analyzed differently, their similarities ignored.<sup>1</sup> The taxing system can be made more rational and simpler by identifying such anomalies and eliminating them from the law.

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<sup>1</sup> The inconsistent tax consequences considered in this article are the product of faulty judicial and administrative interpretation of broad or ambiguous statutory language. There are other sources of inconsistent treatment, most notably, express statutory mandate. Congress may prescribe inconsistent tax treatment for comparable activities either to achieve a nontax objective or by seeming inadvertence. For an example of the former, compare the favorable consequences of exploiting patents provided by § 1235 with the consequences of transactions in intellectual properties governed by § 1221(3). Inadvertent inconsistencies arise, with increasing frequency, from efforts to correct specific manifestations of broader problems while leaving the basic problem and its other manifestations untouched. For a

This article examines a financial transaction that is commonplace in the life of many corporations: a partial shift of corporate ownership from an existing stockholder group to new investors that is accompanied by a withdrawal of investment by one or more members of the old group. Three of the more common ways of achieving this result are examined here: the *Zenz* redemption, a statutory merger or consolidation accompanied by a distribution of boot, and a liquidation-reincorporation.<sup>2</sup> Although not compelled by any provision of the Internal Revenue Code, the income tax consequences to shareholders receiving corporate distributions incident to such transactions are likely to be very different depending upon the route chosen. The differing treatments have evolved because neither the courts nor the Commissioner has given due regard to the relevance of the fresh investment from the new investor group to the characterization of the disposition of corporate interests by the old stockholder group.

This article first demonstrates the proper relevance of fresh investment to the tax consequences of the partially withdrawing stockholder in the context of a simple redemption. It then shows that consistent treatment of fresh investment in the three transactional formats both produces consistent results among comparable transactions, thereby enhancing the rationality of the taxing system, and yields superior results to the participants in each form of transaction viewed in isolation.

### The Problem in General

One of the more fruitful sources of inconsistent tax consequences under the Internal Revenue Code is the need to distinguish for income tax purposes the disposition of an interest in property from the exploitation of the interest in an income producing activity. The Code generally assumes a sharp distinction between these categories and imposes widely differing income tax burdens on financial receipts from the seemingly dichotomous activities.<sup>3</sup> Dispositive transactions are taxed quite

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treatment of one such effort, see Coven, *Liabilities in Excess of Basis: Focht, Section 357(c)(3) and the Assignment of Income*, 58 OR. L. REV. 61 (1979).

<sup>2</sup> There are other techniques for accomplishing such a shift of investment. For example, the assets of an existing corporation, together with fresh investment, may be transferred to a new corporation in exchange for stock and, to the withdrawing stockholders, cash. The consequences of such a transaction are governed by § 351. For a recent article which applies to § 351 a dispositive transaction analysis similar to that used here, see Tillinghast and Paully, *The Effect of the Collateral Issuance of Stock or Securities on the "Control" Requirement of Section 351*, 37 TAX L. REV. 251 (1982).

<sup>3</sup> A few recently enacted provisions of the Code are based on the contrary assumption, namely, that a single transaction may contain elements of both a sale

lightly. The proceeds of a disposition are taxed only to the extent that they exceed the taxpayer's remaining investment in the property interest.<sup>4</sup> Moreover, the taxable amount is frequently eligible for the highly favorable rate of tax imposed on capital gains.<sup>5</sup> On the other hand, receipts from the exploitation of property are fully subject to tax and are taxed at ordinary income rates.<sup>6</sup>

Regrettably, the world that we attempt to tax fails to draw this distinction. Complete dispositions and mere exploitations are at best points on a continuum of commercial activities. Consequently, the lines drawn in the various contexts in which this distinction carries controlling significance have not been entirely satisfactory and have produced a disproportionately large amount of controversy.<sup>7</sup>

The inherent arbitrariness of the distinction between gain or loss on a disposition and a return on a retained interest is nowhere more evident than in the rules that apply the distinction to corporate distributions.<sup>8</sup> A sale of a portion of a stock interest in a corporation to an unrelated person necessarily produces a *pro tanto* reduction in the seller's continuing interest in the corporation and thus is treated as a disposition.<sup>9</sup> Conversely, a mere *pro rata* distribution with respect to a retained stock

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and an exploitation. For example, § 1253 provides that in the context of what otherwise constitutes the sale of a franchise or trademark, the receipt of payments contingent upon productivity or use are denied capital gains treatment. Such bifurcation of a single transaction, however, remains the rare exception.

<sup>4</sup> I.R.C. § 1001.

<sup>5</sup> I.R.C. §§ 1201, 1202 and 1221. In general, gain of a noncorporate taxpayer on a disposition of property is taxed at a rate equal to 40% of the otherwise applicable tax rate.

<sup>6</sup> See I.R.C. § 61.

<sup>7</sup> One of the currently more notorious controversies surrounds the distinction between installment sales and financing leases. Taxpayers and the Service have quarrelled for decades over whether a manufacturer or financial intermediary has sold or merely leased property to the user. *See, e.g.,* *Starr's Estate v. Commissioner*, 274 F.2d 294 (9th Cir. 1959) and *Rev. Proc. 75-21*, 1975-1 C.B. 715, *modified*, *Rev. Proc. 76-30*, 1976-2 C.B. 647, *Rev. Proc. 79-48*, 1979-2 C.B. 529, *Rev. Proc. 81-71*, 1981-2 C.B. 731. Considerable confusion was added to this branch of the controversy when Congress provided that for the purpose of permitting trafficking in the tax benefits of the Accelerated Cost Recovery System, transactions that everyone agreed did not constitute leases henceforth would be regarded as leases. I.R.C. § 168(f)(8).

<sup>8</sup> Prophetically, the Supreme Court's first confrontation with the definition of income for tax purposes arose in the context of a corporate distribution of a stock dividend which the Court held was not taxable. *Eisner v. Macomber*, 252 U.S. 189 (1920). In dissent, Justice Brandeis argued that the distribution was the functional equivalent of a cash dividend and reinvestment and should be taxed in the same manner.

<sup>9</sup> I.R.C. § 1001. Of course, it is always possible to pretend to sell stock, in which event the purported disposition may be disregarded. *See, e.g.,* I.R.C. §§ 267(a)(1) and 1091.

interest is usually a return on that stock investment, a dividend.<sup>10</sup> A sale of stock to the issuing corporation straddles these categories and requires arbitrary characterization. While other solutions might be possible,<sup>11</sup> the Code recognizes that such a redemption may more nearly resemble either a disposition or a dividend and thus characterizes a redemption as a disposition or a dividend, depending on which category the particular transaction more closely resembles.

For corporate distributions which occur in isolation—for simple redemptions not involving multiple corporations, for example—a reasonable measure of consistency of characterization has been achieved for the great majority of transactions. Redemptions deemed to be dispositions are distinguished from those that are not under the largely mechanical safe harbor rules of section 302(b). Since a disposition should result in a reduction of a taxpayer's continuing ownership interest, while a dividend typically does not, section 302 provides that a redemption is taxed as a disposition only if the effect of the redemption is to materially diminish the redeemed stockholder's continuing interest in the corporation. Section 302(b)(2), for example, specifies that a stockholder's proportionate interest is regarded as materially reduced if it is less than 80 percent of the proportionate interest held prior to the redemption.<sup>12</sup>

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<sup>10</sup> Section 316(a) defines a dividend as any distribution of property from a corporation to its stockholders to the extent of the corporation's earnings and profits. "Earnings and profits" is not comprehensively defined but generally corresponds to the accounting concept of retained earnings. Under §§ 301(a) and (c)(1), to the extent that a corporate distribution is a dividend as so defined, it is fully taxed at ordinary income rates, unless the distribution is governed by a more specific section of the Code. Thus, for example, a distribution in the form of a stock redemption which meets the requirements of § 302(b) is treated as a sale (I.R.C. § 301(a)), not as a dividend.

<sup>11</sup> For a summary of several possible approaches to changing the present method of taxing redemptions, see ALI, *FEDERAL INCOME TAX PROJECT* 100-29 (Tent. Draft No. 2, 1979) (Subchapter C, Corporate Distributions).

<sup>12</sup> Actually, of course, the requirements of § 302(b)(2) are a bit more complicated:

(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—

While plainly arbitrary, this “substantially disproportionate” test of section 302(b)(2) possesses the twin virtues of relative clarity and simplicity and eliminates much of the confusion that existed under prior law.<sup>13</sup>

(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 determination 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.

Moreover, § 302(c)(1) provides that in computing stock ownership, the attribution rules of § 318(a) are applicable. The complications added by stock attribution are not of present concern.

The application of the substantially disproportionate rule is illustrated as follows. Assume that individual *A* owns 40 of the 100 outstanding shares of a single class of stock in a corporation and that 10 of those shares are redeemed. *A*'s percentage interest in the corporation falls from 40% (40/100) to 33% (30/90). Since 33% is more than 80% of 40%, the redemption does not meet the safe harbor rule of § 302(b)(2). Unless the redemption meets one of the other tests of § 302(b), the distribution is taxed as a dividend.

Section 302(b) sets forth three other tests of general application for avoiding dividend treatment, none of which is of particular interest here. The complete termination of a stockholder's interest in a corporation avoids dividend treatment under § 302(b)(3). A redemption of all of a stockholder's shares would always satisfy the substantially disproportionate test were it not for the stock attribution rules. The advantage of the complete termination provision is that, subject to several lengthy and complex rules, the family attribution rules are waived for the purpose of determining whether the redemption has completely terminated the stockholder's interest. I.R.C. § 302(c)(2).

The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 [hereinafter cited as TEFRA], eliminated the rules allowing distributions in partial liquidation to be taxed as dispositions under § 331 (see § 346(a) before its amendment by TEFRA), but added a new exception from dividend treatment in § 302(b)(4) that is designed to continue sales treatment for distributions to non-corporate stockholders incident to such transactions. TEFRA, §§ 222(c) and (d). The definition of a partial liquidation, now contained in § 302(e), remains essentially unchanged and does not normally encompass any of the transactions considered herein.

Finally, § 302(b)(1) provides a catch-all rule that dividend treatment is not imposed “if the redemption is not essentially equivalent to a dividend.” The scope of this general test is still emerging, although the Supreme Court has required that the redemption cause a “meaningful reduction” in stock ownership, taking into account the stock attribution rules. *United States v. Davis*, 397 U.S. 301 (1970).

<sup>13</sup> For brief histories of the confused pre-1954 caselaw, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS*

Corporate distributions often do not occur in isolation, however, but are the mere accompaniments of more fundamental adjustments to the capital structure of the redeeming corporation. The rational application of the substantially disproportionate test has proven elusive in cases in which distributions are only parts of larger transactions in which new investors are introduced. The complicating factor in such a case is that the fresh investment independently alters the interest in the corporation of the recipient of the distribution. Surprisingly enough at this date, the relevance of this independent expansion of the value of the corporation to the characterization of the concurrent distribution has not been established.

Consider, for example, a corporation that has a net worth of \$1 million and is equally owned by two unrelated stockholders. Wishing, perhaps, to retire from the active management of the business and harvest a part of the gains in their investments, the shareholders have located an individual willing to invest \$600,000 in the corporation. As part of the transaction in which the new investor is brought in, each shareholder will convert 40 percent of his investment to cash, leaving each with 25 percent and the new investor with 50 percent of the corporation's stock. The most expeditious manner in which such a substitution of investment could occur would be a sale of 40 percent of the outstanding stock of the corporation directly from the old stockholders to the new for \$400,000, accompanied by the latter's investment of \$200,000 in the corporation. In a no tax world, or perhaps even in a world free of the corporate income tax, the parties typically would not seek a more complex solution to their desired objective. In our world, however, very substantial income tax advantages can accrue to both buyer and seller if they choose to deal, not with each other, but rather with the corporation.<sup>14</sup> Thus, the parties likely will prefer to cause the corporation to redeem the holdings to be liquidated while the new investor acquires only newly issued stock. If

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¶¶ 9.01-.03 (4th ed. 1979) [hereinafter cited as BITTKER & EUSTICE]; Dean, *Redemptions: Dividend or Capital Gain; Death Taxes, Related Corporations*, 13 N.Y.U. INST. ON FED. TAX'N 547 (1955).

<sup>14</sup> On direct sale of stock, the seller is taxed, normally at capital gains rates, on his gain in the particular shares sold. The sale has no effect at the corporate level. A redemption given sale treatment produces precisely the same tax to the seller. However, the redemption accomplishes a distribution of earnings and profits. See I.R.C. § 312(3); Rev. Rul. 79-376, 1979-C.B. 133. This reduction in earnings and profits may benefit all continuing stockholders, most prominently by reducing the amount of any subsequent distributions that may be taxed as dividends. Perhaps most importantly, to the extent of the redemption, the buyers are in effect acquiring an interest in the corporation through the use of the assets of the corporation, but the buyers are not taxed on the value of the assets so used for their benefit. See *Edenfield v. Commissioner*, 19 T.C. 13 (1952); Rev. Rul. 69-608, 1969-2 C.B. 42.

each stockholder liquidates a portion of his investment through a distribution from the corporation, it becomes necessary to characterize the redemption under section 302(b)(2) as either a disposition of this portion or as a return on a continued investment, the equivalent of a dividend.

For the purpose of making this determination, the Commissioner appears to be prepared to concede that the change in proportionate interest of each withdrawing shareholder should be calculated by comparing (a) his interest in the corporation prior to the purported redemptions and the issuance of stock to the new investor with (b) the interest held following these transactions. That is, the redemptions and the corporate sale will be integrated and effect will be given to the reduction in ownership attributable to these transactions. Accordingly, the interest of each shareholder will be regarded as declining from 50 to 25 percent. Since this reduction in interest substantially exceeds the 20 percentage points required by the safe harbor rule of section 302(b)(2),<sup>15</sup> the redemption will be treated as a sale subject to capital gains taxation.

If the new investor is another corporation, the fresh investment could be obtained through some form of corporate combination, for example, a statutory merger or consolidation accompanied by distributions to the old stockholders. Assume the new investor is a corporation that has assets worth \$600,000 and no liabilities. The new investor and the corporation discussed earlier might consolidate into a new corporation, C, under a plan providing for (a) the exchange of all stock of the new investor for 50 percent of the shares of C and (b) the exchange by each of the old shareholders of his stock for 25 percent of the C stock and \$200,000 in cash.

In this case, the Commissioner, with some backing from the courts, would take the position that the withdrawal of funds and consolidation cannot be integrated and that the change in ownership attributable to the consolidation must be disregarded in testing for dividend equivalence. Under this view, the proportionate interest of each old stockholder is deemed not to change at all, and the case is analyzed as though each of them owned 50 percent of a \$1 million corporation before the transaction and afterwards owns 50 percent of a \$600,000 corporation. The mechanical test of section 302(b)(2) is not met, according to the Service, and, apparently, the distribution is taxed in a manner similar to the taxation of an ordinary dividend.<sup>16</sup> Thus, notwithstanding that the re-

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<sup>15</sup> The reduction also meets the further requirement that the redeemed shareholder own less than 50 percent of the voting stock immediately after the redemption. I.R.C. § 302(b)(2)(B).

<sup>16</sup> The taxation of distributions incident to reorganizations, or "boot," is governed by § 356. In testing for dividend equivalent under that section, however, the rules of § 302 are applied by analogy. See *infra* text accompanying notes



organization leaves the shareholder in precisely the same economic position as the redemption assumed earlier, the consequences to him will be quite different. While capital gains treatment is relatively easy to obtain under the rules the Commissioner applies to a simple redemption, it is virtually impossible to obtain under the rules applied to an analogous reorganization.

As a third alternative, the stockholders could cause their corporation to be completely liquidated, each receiving assets worth \$500,000 in the liquidation, retaining \$200,000 of the distributed assets, and contributing \$300,000 of the assets to a new corporation in exchange for 25 percent of its stock. If as a part of the same transaction the new investor contributes \$600,000 to the new corporation in exchange for 50 percent of its stock, the parties will be left in the same positions that they would have occupied under the two forms of this transaction considered previously.

Whether the corporate assets retained by the shareholders in the liquidation-reincorporation will be treated as the equivalent of a dividend again depends on the effect given to the fresh investment. The Commissioner has argued that the fresh investment should not be integrated to any extent with the reincorporation and distribution and that each stockholder should be taxed as if he had received a distribution in the nature of a dividend from a continuing corporation. The courts, however, have not only integrated the transactions but have held that the presence of fresh investment requires that the shareholder be treated as having disposed of his prior investment, thus entitling him to capital gains taxation.

Given the identity of financial result to the shareholder in each of these three forms of transactions, it would plainly be desirable for the federal income tax consequences of the partial withdrawal of investment to be as identical as the Code permits. An analysis of the proper significance of fresh investment to the characterization of the distribution to the shareholder in each of these contexts indicates that none of the results presently obtained in these transactions is correct. In each, the fresh investment should be integrated with the withdrawal, but it is relevant to the characterization of the withdrawal only to the extent the fresh investment is the functional equivalent of a disposition. As will be demonstrated, to the extent that the fresh investment exceeds the distribution to the old shareholder, the fresh investment is not relevant to either the character-

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38-40. If reorganization boot is found to have the effect of a dividend, it is usually taxed in the same manner as an ordinary dividend. One significant difference is that the amount of boot subject to tax cannot exceed the stockholder's gain on the reorganization exchange. I.R.C. § 356(a)(2). That limitation is rarely of significance in the transactions considered herein.

ization of the distribution or the finding of a reorganization. Accordingly, whether the fresh investment comes as a direct investment in the existing corporation or by virtue of a statutory merger or consolidation, the interest of each old shareholder should be regarded as declining from 50 to 30 percent.

In the liquidation-reincorporation form of the transaction, the distribution to be characterized is the distribution in liquidation. It should be integrated with the subsequent reincorporation in determining whether the overall transaction constitutes a reorganization. In making this determination, the fresh investment is not relevant to the application of the traditional continuity of interest test applied to all reorganizations.<sup>17</sup> On the facts supposed, since each shareholder retains 60 percent of his prior investment as a continuing equity interest, the continuity of interest test is met. Accordingly, the transaction should be treated as an F reorganization. Thus, the \$200,000 retained by each old stockholder would be treated as a distribution of boot incident to a reorganization or as a redemption accompanying the reorganization,<sup>18</sup> and the shareholder should be taxed precisely as he was taxed in the other versions of the transaction.

### The Zenz Redemption

The simplest situation in which a corporate distribution occurs in tandem with a fresh investment is a redemption coupled with a purchase of stock by the new investor from the old shareholder or the corporation. The 1954 decision of the Sixth Circuit in *Zenz v. Quinlivan*<sup>19</sup> is the starting point for the analysis here. Mrs. Zenz had inherited from her husband all outstanding shares of a corporation which had accumulated a substantial and perhaps excessive portion of its earnings. Mrs. Zenz wished to dispose completely of the corporation. She sold somewhat less than one half of her shares. Three weeks later the corporation redeemed the balance of her stock for an amount that approximated its earned surplus. The Commissioner evidently argued that the redemption must be characterized separately from the sale of stock and that because the effect of the postsale redemption was the same as if the redemption had preceded the sale, it should be subject to tax in the same manner.<sup>20</sup>

<sup>17</sup> See *infra* text accompanying notes 91–93.

<sup>18</sup> Whether distributions accompanying an F reorganization constitute reorganization boot or are to be taxed separately under §§ 301 and 302 remains in dispute. See *infra* text accompanying note 129.

<sup>19</sup> 213 F.2d 914 (6th Cir. 1954).

<sup>20</sup> The position of the Commissioner is not described with particular clarity by either the court of appeals or the district court, whose opinion appears at 106 F. Supp. 57 (N.D. Ohio 1952). It does appear that the Commissioner relied in part

Since a presale redemption would not have altered the proportionate interest of a sole stockholder such as Mrs. Zenz, the Commissioner concluded that the redemption was essentially the equivalent of a dividend. The Court of Appeals, however, held that a redemption that in fact completely terminated a stockholder's interest in a corporation could never be the equivalent of a dividend and thus sustained Mrs. Zenz's treatment of the sale and redemption as dispositions entitled to sales treatment.

The court could have reached this result by agreeing that the redemption was a transaction to be tested separately from the stock sale but rejecting the Commissioner's rather strained reconstruction of the order of events. It is not entirely certain that the court intended to go any further than that. Nor at the time was the Commissioner prepared to read the *Zenz* opinion expansively. While he almost immediately announced his agreement with the decision, the retreat was limited to the particular facts of the case.<sup>21</sup> Nevertheless, the opinion suggested that under a step transaction analysis, the court had viewed the sale and redemption as a single, integrated transaction in determining whether the change in the stockholder's interest in the corporation was sufficient to avoid dividend equivalence.<sup>22</sup>

Whether intended in 1954 or not, the decision in *Zenz v. Quinlivan* has, by a series of incremental expansions of its reach, come to stand for the broader proposition. Just seven years later, the Eighth Circuit was presented in *United States v. Carey*<sup>23</sup> with a similar transaction in which the parties had somewhat cavalierly reversed the order of events. Two equal stockholders caused their corporation to make a pro rata redemption of approximately one half of the stock of each, whereupon one of the stockholders sold his remaining shares to the other and a new investor. In the district court, the government sought to charge both stockholders with dividend income, but both taxpayers prevailed. The government appealed only with respect to the stockholder who retained an interest in the corporation. It did not appeal the decision in favor of the

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upon the dearth of prior dividend distributions and the resulting accumulation of earnings in arguing that the transaction amounted to a circuitous attempt to distribute earnings in a manner essentially equivalent to a dividend. *Id.* at 61. However, in Revenue Ruling 77-226, 1977-2 C.B. 90, the Commissioner described the government's position in *Zenz* as set forth in the text.

<sup>21</sup> Rev. Rul. 54-458, 1954-2 C.B. 167. The "particular" facts stressed by the Commissioner were the sale preceding the redemption and the complete termination of interest. In the following year, the Commissioner extended his concurrence to cases arising under the 1954 Code. Rev. Rul. 55-745, 1955-2 C.B. 223.

<sup>22</sup> At several points in the appellate opinion, the court variously appears to address the separate redemption or the overall transaction as accomplishing the complete termination of Mrs. Zenz's interest.

<sup>23</sup> 298 F.2d 531 (8th Cir. 1961).

terminated stockholder for the stated reason that his "interest in the corporation was terminated as a result of the transaction in question."<sup>24</sup>

Following this concession, the *Zenz* doctrine has been extended to stand for the proposition that if a shareholder disposes of an interest in a corporation in two factually related steps, one being a sale and the other a redemption, those steps are integrated in applying section 302. Further, if as a result of this integrated transaction the stockholder is left owning no stock in the corporation, the transaction is a complete termination of interest under section 302(b)(3). As so extended, the doctrine is unquestionably proper.

While this extension of the *Zenz* doctrine is not controversial, it is necessary, in order to appreciate the proper scope of the doctrine and its application to the transactions that are the subject of this article, to understand why the results obtained through its application are correct.

Two quite separate legal issues must be addressed in the application of the *Zenz* doctrine, or indeed any other manifestation of the step transaction analysis. The first concerns the level of factual relationship among the discrete steps that must exist before these steps will be regarded as components of an integrated whole in applying section 302. The requisite level has not been defined consistently.<sup>25</sup> In some instances, the courts have required an artificially strong relationship, such as a binding contract, before applying the step transaction doctrine,<sup>26</sup> while in other cases a surprisingly weak relationship has sufficed.<sup>27</sup> Generalization is thus hazardous at best, but most cases disclose a pragmatic, common sense approach. Where the steps are necessary to achieve the result sought by the parties, have been arranged in advance, and are executed during a relatively brief period of time in conformity to the original plan,

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<sup>24</sup> *Id.* at 532 n.2. The enduring importance of *Carey* is attributable to this concession, although the court's disposition of the case before it is also of interest. If the redemption were not a dividend to the terminated stockholder, the court reasoned, the identical redemption could not be a dividend to the continuing stockholder. It held that the taxpayer before it was entitled to sales treatment. Since the interest of the continuing stockholder actually increased as a result of the overall transaction, this decision is obviously wrong and may in part have been responsible for the reluctance of the Commissioner to extend the *Zenz* doctrine to partial redemptions.

<sup>25</sup> Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX'N 247 (1954).

<sup>26</sup> *E.g.*, *Commissioner v. Gordon*, 391 U.S. 83 (1968); *American Bantam Car Co. v. Commissioner*, 11 T.C. 397 (1948), *aff'd per curiam* 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

<sup>27</sup> *E.g.*, *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969) (transfer of stock in target for cash and stock of acquiring corporation followed by merger of target into its new parent; held, steps collapsed and initial exchange treated as part of reorganization although old stockholders of target did not participate in merger and may not have been aware that it occurred).

the step transaction doctrine is almost uniformly applied.<sup>28</sup> When these tests are met, the discrete steps taken by the parties are in fact components of a single, continuing transaction. Thus, it is not only appropriate but logically necessary to integrate those steps and to analyze their income tax consequences in that light. The facts of *Zenz v. Quinlivan* itself, and of most cases in which the parties have sought the same result, clearly meet this standard for integration.

The second question is whether the change in stock ownership produced by the sale affects the characterization of the redemption. It does not necessarily follow from the decision to integrate that the sales component of the transaction is relevant to the characterization of the redemption.<sup>29</sup> The relevance of one step in a transaction to another is a question of law which, in this context, must be resolved by reference to the policy embodied in the substantially disproportionate test of section 302(b)(2), a mechanical test designed to evaluate the extent to which a redemption resembles a sale of stock to a new investor. The plain focus of the substantially disproportionate test is upon the reduction in the redeemed shareholder's ownership, not upon whatever correlative increase in interest may be obtained by others. It is not material whether the increase in ownership is obtained by one who previously owned stock in the corporation (as in a simple redemption) or by a new investor (as in a redemption coupled with a sale). An ownership shift produced by contemporaneous sales of stock thus has the same relevance to the characterization of the redemption as the shift resulting from the redemption alone. Accordingly, the *Zenz* integration doctrine is the correct method of analyzing redemptions that are factually integrated with sales.

A crucial distinction that will shortly be developed must, however, be observed. While all of the redeemed stockholder's transfers are relevant to the computation of the change in proportionate interest, not all

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<sup>28</sup> For a typical example, see *West Coast Marketing Corp. v. Commissioner*, 46 T.C. 32 (1966). See generally BITTKER & EUSTICE, *supra* note 13, at ¶ 14.51.

<sup>29</sup> For example, a B reorganization is an acquisition of stock in the target corporation in exchange solely for voting stock of the acquiring corporation. If, incident to such a reorganization, debt of the target is acquired for debt of the acquiring corporation, the debt for debt exchange does not destroy the reorganization merely because the exchange goes beyond the transaction described in § 368(a)(1)(B). Rather, the exchange is irrelevant to the reorganization and therefore is taxed separately. Rev. Rul. 69-142, 1969-1 C.B. 107. Cf. Rev. Rul. 70-269, 1970-1 C.B. 82 (stock options).

This distinction between relevance and factual integration has recently been developed in Chirelstein & Lopata, *Recent Developments in the Step-Transaction Doctrine*, 60 TAXES 970 (1982). The authors observe that in step transaction litigation, the results reached are determined both by factual integration and by "policy and Code structure." That is, the issue depends on whether the integrated step is relevant to the policy of the substantive Code provision in question.

changes in proportionate interest are relevant to the characterization of a corporate distribution. This limitation of the legitimate scope of the *Zenz* doctrine does not appear to have been observed when the doctrine was extended to substantially disproportionate redemptions.

While the *Zenz* integration doctrine rapidly became established in the jurisprudence of section 302(b)(3), it remained unclear for over 20 years whether or to what extent sales would be integrated with redemptions under section 302(b)(2) if a redeemed stockholder retained an interest in the corporation.<sup>30</sup> The logic of the doctrine applies to this case, however, and it was so applied in Revenue Ruling 75-447.<sup>31</sup> *Zenz* was there characterized as holding that if a sale and redemption occur as parts of a single transaction, both steps must be integrated for the purpose of testing for dividend equivalence. The order of events, the ruling says, is irrelevant. Thus, the ruling concludes, for the purposes of the substantially disproportionate test of section 302(b)(2), the stockholders' interests in the corporation prior to the redemption or sale are to be compared with their holdings following both steps in the transaction.

The ruling gives an example: A corporation having 100 shares of stock outstanding was owned by two equal stockholders. Each stockholder sold 15 of his 50 shares to a new investor and caused the corporation to redeem five of his shares. The ruling held that the change in proportionate interest of each of the old stockholders was to be measured by comparing his initial holding of 50/100 with his ultimate holding of 30/90. Since 33 percent is less than 80 percent of 50 percent, the safe harbor test of section 302(b)(2) is satisfied and both of the old stockholders are entitled to capital gains taxation with respect to both the sale and the redemption.

The ruling also addressed another variation that had not previously been the subject of either a ruling or court decision. The desired shift in corporate ownership could be accomplished without any direct sales of stock at the shareholder level. Instead, the old and the new stockholder groups might deal exclusively with the corporation, the old stockholders having a greater amount of their stock redeemed and the new investor acquiring stock by an original issue from the corporation. In the example in the ruling, each of the old stockholders could have caused the corporation to redeem 20 shares of his stock, and the new investor could have purchased 30 shares from the corporation. The ruling treated these alternative forms of accomplishing a shift of investment identically. Under the again expanded *Zenz* doctrine, therefore, a redemption is in-

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<sup>30</sup> See *Friend v. United States*, 345 F.2d 761 (1st Cir. 1965).

<sup>31</sup> 1975-2 C.B. 113.

tegrated with a sale of stock at the corporate level, and the change in proportionate ownership is measured on the completion of both steps in the transaction.

The extension of the *Zenz* doctrine to the integration of corporate level sales is also correct. The corporate sale variation is merely an indirect method of achieving precisely the same result as previously was obtained by a direct stockholder sale. Since the two variants are functional equivalents, they should bear the same income tax burden. That the new and old groups do not deal directly with each other is irrelevant. If the corporate sale were not integrated with the redemption, the old stockholders would be regarded as not reducing their interests at all—a plainly unrealistic conclusion. Indeed, the redemption of 40 shares of stock is somewhat illusory since the new investor, by prearrangement, replenishes the value of the corporation to the extent of his new investment. If, for analytical purposes, this transitory flow of value were washed out, the transaction might be reconstructed as a redemption of ten shares of stock from the old stockholders and a direct sale of 30 shares from them to the new investor—the very transaction considered first.<sup>32</sup> Thus, Revenue Ruling 75-447 is correct in concluding that to the extent fresh investment constitutes the functional equivalent of a direct stockholder sale of stock, the change in proportionate ownership it produces is entirely relevant to the characterization of the accompanying redemption.

The integration of corporate sales with redemptions, however, creates a factual possibility that is not present when the sales are made by stockholders. When stock sales are made by a corporation rather than its old stockholders, more shares can be issued than are redeemed and the corporate entity may expand rather than contract as a result of the combined transactions. The new investor, for example, might wish to acquire, not 33 percent of the corporation, but 50 percent and accordingly might invest a greater amount in exchange for 60 shares of stock. After the redemption of 40 shares from the two old stockholders, the corporation would have 120 shares outstanding.<sup>33</sup> Such an expansion could not occur

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<sup>32</sup> It is not suggested here that redemptions and corporate sales should generally be reconstructed as shareholder level sales. Rather, the suggestion is merely that since the resulting proportionate change in ownership is identical regardless of which format is employed, the characterizations of the distributions should also be identical. On appropriate facts, however, such a reconstruction would be warranted. *See, e.g.,* *Wall v. United States*, 164 F.2d 462 (4th Cir. 1947). *See also* *Waterman S.S. Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971).

<sup>33</sup> For the sake of simplicity, in this and subsequent illustrations it is assumed that the value of a share of stock in the corporation remains unchanged and, when two corporations are involved, and that their shares are of equal value. A contrary

if only stock previously outstanding in the hands of the old stockholders had been sold.

If Revenue Ruling 75-447 were applied literally to a redemption accompanied by such a corporate sale, a plainly erroneous result would obtain. In the example, each of the old stockholders would be regarded as having reduced his proportionate interest in the corporation from 50/100 or 50 percent to 30/120 or 25 percent, a reduction of 50 percent, when in fact he liquidated only 40 percent of his prior investment, 20 shares out of 50. Effect would be given not only to new investment that replaced the value distributed in the redemption but also to the further fresh investment that expanded the size of the corporation. Yet, to the extent of this expansion, the resulting shift in proportionate ownership does not reflect a disposition and thus should not be relevant to the characterization of the redemption.

While it is unquestionably correct as a factual matter to integrate redemptions with sales, whether by the redeemed stockholder or by the corporation, a blind application of the *Zenz* integration doctrine and the mechanical formula of section 302(b)(2) cannot be permitted to obscure the central issue that these rules address. Section 302(b) is designed to measure the extent to which a liquidation of investment by means of a redemption resembles a sale. In testing for that similarity, the formula contained in section 302(b)(2) refers to the stockholder's proportionate interest immediately after the redemption because, in the simple redemption the formula was designed to address, that resulting proportionate interest accurately reflects the extent to which the redemption shifted ownership of the corporation to another. The shareholder's resulting proportionate interest is the appropriate measure of the change in proportionate interest in the case of a simple redemption, not accompanied by any fresh investment, because that resulting interest is solely produced by the redemption.

Section 302 was not drafted, however, to measure sale resemblance in a transaction accompanied by fresh investment. In extending the scope of section 302 to encompass such a shift in investment, the formula of section 302(b)(2) must be applied consistently with its purpose of measuring the degree of similarity between the transaction in question and a sale. If a redemption is accompanied by fresh investment made directly in the corporation, but a corporate contraction nevertheless results because the redemption distribution exceeds the new investment, the net effect of the transaction is identical to a sale of stock directly from the old stockholder to the new investor accompanied by a redemption. Both

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assumption would affect only the complexity of the illustration, not the principle illustrated.



the redemption and the constructive sale reduce the shareholder's investment. The stockholder's final proportionate interest is solely a product of his dispositions, as in a simple redemption, and thus can properly be used in determining whether the change in proportionate interest by virtue of the aggregate of these dispositions is sufficient to cause the redemption to be treated as a sale.

On the other hand, the mere receipt by a corporation of fresh investment, not accompanied by a redemption, is not a disposition by the existing shareholders. The existing shareholders have not thereby reduced their investments and indeed under our system of taxation have not participated in a transaction regarded as a taxable event.<sup>34</sup> The decline in the proportionate interests of the existing shareholders caused solely by such a fresh investment does not at all resemble a sale of stock at the shareholder level, and is of a very different character than the declines in interest that section 302(b)(2) was designed to measure.

If a redemption is accompanied by fresh investment which results in an expansion of the corporate entity, the effect of the combined transaction is the same as a sale of stock at the shareholder level plus a further fresh investment. To the extent that the fresh investment does not exceed the redemption distribution, the investment reflects a disposition of stock by the existing shareholder and is relevant to the characterization of redemption. On the other hand, to the extent that the fresh investment exceeds the redemption distribution, it does not reflect a disposition by the existing shareholder and is entirely irrelevant to the characterization of the contemporaneous redemption. Since the reduction in proportionate ownership produced by a corporate expansion is not relevant to the comparison section 302(b)(2) was designed to make, the change in proportionate ownership attributable to the expansion must be excluded from the computation.

It follows that in computing the interests of the redeemed stockholders after the transaction, the continuing stock interest must be measured with respect to an amount no greater than the value of their old investment. If the value of each share is not independently altered in the transaction, the denominator of the "after" fraction used under section 302(b)(2)

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<sup>34</sup> The law could be otherwise. Fresh investment in a corporation could be reconstructed as a sale by each of the old stockholders of a portion of his stock to the new investor followed by a contribution of the proceeds of the sale to the corporation. Such a characterization would merely accelerate the tax on the old stockholders' unrealized appreciation. The acceleration does not seem justified, however, since no value has been removed from corporate solution. The only effect of the transaction upon the old stockholders is that their stock in the corporation now represents an interest in an altered mix of assets—a circumstance that could result from corporate action not involving new investment which would clearly not amount to a disposition by the old stockholders.

cannot exceed the number of shares outstanding before the transaction. In the example, notwithstanding that the new investment increased the total shares outstanding from 100 before to 120 after the transaction, the continuing interest of each of the old stockholders in his prior investment is  $30/100$ , not  $30/120$ . Accordingly, the proportionate interests of each of the old stockholders should be regarded as declining from  $50/100$ , or 50 percent, to  $30/100$ , or 30 percent. So treating the old stockholders as disposing of 40 percent of their investments accurately reflects the extent to which they have transferred an interest in their old investments to the new investors by the redemption and corporate sale of stock. The additional investment by the new investor in exchange for 20 shares of stock is simply irrelevant to this measurement. Neither is it relevant that the retained 60 percent of the old investment is now represented by a 50 percent interest in a somewhat expanded corporation. If the old stockholders were treated as retaining  $30/120$ , or 25 percent, of their investment, they would be regarded as having disposed of 50 percent of their investment, which they did not do. Taking the fresh investment into account would overstate the extent of the reduction in interest and erroneously extend sales treatment to distributions that did not entail a sufficiently material shift in interest to be entitled to such treatment.

Moreover, whether a redemption has produced a sufficiently material shift in the ownership of the corporation to be entitled to sales treatment should not be affected by the extent to which the value of the corporation expands by virtue of fresh investment. Since that investment is irrelevant to the characterization of the redemption, its effect should be neutral. If one of the old stockholders causes 10 of his 50 shares to be redeemed, for example, the redemption should be regarded as reducing his continuing interest in the corporation by no more than 20 percent, an amount insufficient to meet the substantially disproportionate test, regardless of the number of shares of stock of the corporation outstanding after the transaction. Exactly that neutrality would be achieved by modifying Revenue Ruling 75-447 to address only the continued proportionate interest in the prior investment. Under a literal application of the ruling, the decline in interest would be a function of the level of new investment and could produce a computed decline vastly in excess of 20 percent. If the fresh investment caused the number of outstanding shares to increase to 1,000, for example, the redeeming stockholder would be regarded as reducing his investment to  $40/1000$  or four percent, a reduction of 92 percent and a totally unrealistic result. Indeed, if full effect were given to fresh investment, it would produce the absurd result of converting the most trivial, pro rata redemption of stock from the old stockholders into a disposition entitled to sales treatment if the redemp-

tion were accompanied by a significant offering of stock by the corporation.<sup>35</sup> It seems most unlikely that such a moratorium on the general rule of section 302 was intended by Congress, the court in *Zenz v. Quinlivan*, or by the draftsmen of Revenue Ruling 75-447.

Most *Zenz* transactions do not result in corporate expansions. Quite the contrary, a common objective in combining sales and redemptions is the reduction in the value of the corporation to enable employees or children to acquire greater interests than would otherwise be possible. In addition, these transactions are commonly used to withdraw unneeded liquid assets from corporate solution at capital gains tax rates. Although the Commissioner has issued several private rulings applying Revenue Ruling 75-447 favorably to taxpayers, none has been discovered in which the value of the corporation increased in the transaction.<sup>36</sup>

It is probable that in issuing Revenue Ruling 75-447, the Commissioner did not appreciate this difference between stockholder level and corporate level sales of stock or the implications of fully integrating the latter under the *Zenz* doctrine. The possibility of a corporate expansion was not mentioned in the ruling. Accordingly, it seems that the moratorium on dividend treatment that the ruling appears to sanction was inadvertent and not intended by the Commissioner. The ruling should not be applied literally in the event of a corporate expansion and should be modified to remove any contrary implication.

The observations thus far with respect to the relevance of fresh investment to the characterization of redemption distributions can be summarized as follows: It is proper, actually logically unavoidable, to integrate redemptions with new investment, whether the new investment occurs by way of a direct sale of stock by a shareholder or a corporate sale. Notwithstanding that integration, fresh investment, to the extent that it increases the value of the corporation, is irrelevant to the characterization of the redemption. Accordingly, in measuring the amount of stock outstanding after the transaction, the amount taken into account should not exceed the lesser of the actual amount outstanding or the amount outstanding prior to the transaction.

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<sup>35</sup> This consequence of Revenue Ruling 75-447 was noted by the American Law Institute, seemingly with disapproval. ALI, *FEDERAL INCOME TAX PROJECT* 106 (Tent. Draft No. 2, 1979) (Subchapter C, Corporate Distributions).

<sup>36</sup> For shareholder sales, *see, e.g.*, LTR 8217138 (Jan. 28, 1982); LTR 8113098 (Dec. 31, 1980); and LTR 8030120 (May 1, 1980). For corporate sales, *see* LTR 8130066 (April 29, 1981). For gifts integrated with a redemption, *see* LTR 8012085 (Dec. 28, 1979). *See also* LTR 8040114 (July 15, 1980) (integration used to sustain sales treatment under section 302(b)(1) when substantially disproportionate test not met).

### Reorganization Boot

If a corporation obtains fresh investment from another corporation and the transaction takes the form of a merger or consolidation of the two corporations,<sup>37</sup> the old stockholders of the former emerge from the transaction, as in the transactions considered before, with a continuing interest in their previously owned assets which are now commingled with the fresh investment, the assets of the acquiring corporation. Also as before, the old stockholders may choose the occasion of the merger or consolidation to reduce their investments by obtaining distributions of cash or property other than stock or securities in the resulting corporation. If such a distribution of cash or property—"boot" in the parlance of the tax specialist—occurs, it must be characterized as either the equivalent of a dividend or as a disposition entitling the stockholder to sales treatment. As in the case of the *Zenz* redemption, the crucial questions are whether and to what extent the reduction of the old stockholders' interests by virtue of the fresh investment affects the characterization of the distribution.

Concededly, the nature of the broader transaction in which the fresh investment is obtained is quite different in a reorganization from the transactions previously considered. As a result, the consequences to the other parties to the transaction and, indeed, to a withdrawing shareholder to the extent of his remaining investment, are quite different. Nevertheless, the boot and redemption distributions are identical in their effects on the old stockholder: In both cases, a partial disinvestment accompanies a retained interest in an altered mix of assets. It would therefore be desirable for the analysis of the characterization of the boot distribution to proceed along the same lines as the analysis of the partial *Zenz* redemption. That result, however, has not been achieved.

Unfortunately, the legal issue begins somewhat differently. If the stockholders in question were stockholders in the target corporation which disappeared in the merger, the characterization of the distribution to them is governed not by section 302 but by section 356(a)(2). The latter provision lacks the safe harbor rules of section 302 and merely provides that the distribution is taxed as a dividend if it has the effect of a dividend.

Until relatively recently, the Commissioner generally argued that any boot distribution in a reorganization had the effect of a dividend to the

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<sup>37</sup> Of the three forms of acquisitive reorganizations authorized by § 368(a)(1), only the A reorganization, a statutory merger or consolidation, liberally permits the use of boot. Accordingly, the discussion in the text is limited to reorganizations qualifying under § 368(a)(1)(A).

extent of the earnings and profits of the acquired corporation.<sup>38</sup> While this so-called automatic dividend rule was applied, the question of integration was simply irrelevant. However, the authority of the automatic dividend position weakened by the early 1970's, and the attention of the courts and the Commissioner then turned to the development of more discriminating tests for dividend equivalence.<sup>39</sup> The obvious analogy was the rules that had evolved under section 302, and when the Commissioner confirmed the demise of the automatic approach, he agreed that the tests of that section, including the substantially disproportionate rule of section 302(b)(2), might serve as guidelines in the application of the boot characterization rule of section 356(a)(2).<sup>40</sup> While the Commissioner did not say so at the time, the tests of section 302 so adopted did not include the *Zenz* integration doctrine.

### The Relevance of Fresh Investment

In contrast to the usual *Zenz*-type redemption, a merger or other reorganization almost always results in an expansion of the resulting corporate entity. Thus the application of the *Zenz* integration doctrine along the lines indicated in Revenue Ruling 75-447 would, in nearly every case, produce the inappropriate results described above.

Indeed, the Commissioner was already painfully aware of the dangers of an integrated transaction approach to the characterization of boot. In *McDonald v. Commissioner*,<sup>41</sup> the taxpayer, as part of a plan for the acquisition of a corporation in which he was the majority stockholder, caused the corporation to redeem a portion of his stock for cash. Imme-

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<sup>38</sup> This automatic dividend rule is generally attributed to the opinion in *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945). See Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573 (1965); Darrell, *The Scope of Commissioner v. Bedford's Estate*, 24 TAXES 266 (1946).

<sup>39</sup> See Gerson, *Boot Dividends and the Automatic Rule: Bedford Revisited*, 11 WM. & MARY L. REV. 841 (1970). The automatic rule was first undermined in a case in which the Commissioner, seeking to resist dividend treatment, argued that the court should not automatically characterize boot as a dividend. *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958). The cases decided during the 15 years following *Idaho Power* analyzed boot in a manner resembling the inquiry under § 302, but apparently no consideration was given to the change in ownership produced by the reorganization itself. See, e.g., *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Ct. Cl. 1969).

<sup>40</sup> Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121. Collectively, these rulings indicated that the Service would apply the meaningful reduction test developed in *Davis v. United States*, 397 U.S. 301 (1970), under the dividend equivalence rule of § 302(b)(1). In addition, Revenue Ruling 74-516 computed the reduction in interest using the substantially disproportionate formula of § 302(b)(2).

<sup>41</sup> 52 T.C. 82 (1969).

diately thereafter, the taxpayer transferred all of his remaining interest in the corporation to the acquiring corporation in a transaction that all parties conceded was a valid reorganization within the definition of section 368(a)(1)(B).<sup>42</sup> Since a B reorganization cannot be accompanied by a boot distribution, the Tax Court was forced to treat the distribution as a redemption controlled by section 302 and *Zenz* rather than as boot governed by section 356. In applying these tests to the redemption, the court integrated the redemption and the reorganization and thus viewed the interest of the taxpayer as declining from over 90 percent before the transaction to an insignificant percentage of the stock of the acquiring corporation after the transaction. Were a similar analysis to be applied to the characterization of boot under section 356, virtually all boot distributions would be regarded as not having the effect of a dividend.

Since the *Zenz* integration rule appeared to produce the wrong result, the Commissioner opted for its opposite in Revenue Ruling 75-83.<sup>43</sup> Without reference to either *Zenz v. Quinlivan* or *McDonald v. Commissioner*, the ruling concluded that boot received by a stockholder of a target corporation would be treated as if it were distributed in a transaction separate from the reorganization occurring prior to the reorganization.<sup>44</sup> As a result, a pro rata distribution of boot would not be regarded as diminishing the continuing interest of the old stockholders to any degree and thus would always be treated as having the effect of a dividend.

Revenue Ruling 75-83 thus began the cycle anew for its analysis is identical to the litigating position asserted by the government in *Zenz v. Quinlivan* over twenty years before. There too, the government contended that the corporate distribution and the new investment should be treated separately and as if the redemption had occurred first. As in the context of a *Zenz* redemption, treating the distribution of boot as separate from the blending of investment that occurs in the merger itself is absolutely untenable.<sup>45</sup> Indeed, if different at all, a boot distribution

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<sup>42</sup> In Revenue Ruling 75-360, 1975-2 C.B. 110, the Commissioner withdrew that concession. Asserting that the Tax Court was correct in viewing the redemption and the later reorganization as a single transaction, the ruling characterized the purported redemption as a boot distribution. Since boot is not permitted in a B reorganization, the ruling concluded that the transaction was not a tax-free reorganization.

<sup>43</sup> 1975-1 C.B. 112.

<sup>44</sup> Although Revenue Ruling 75-83 clearly adopts a separate and before analysis, it states no reasons for that conclusion and in fact does not even acknowledge that the conclusion requires the application of a separate transaction analysis.

<sup>45</sup> The separate transaction analysis of boot in a reorganization is also inconsistent with the analysis of the reorganization itself that is employed by the Commissioner. A nonstatutory prerequisite for reorganization treatment is that the stockholders of the target corporation maintain a continuity of interest in the

is usually more firmly prearranged and more clearly integral to a reorganization than is a redemption which may merely set the stage for a sale of stock. The reduction in proportionate interest suffered by the stockholders of the target corporation as a result of their receipt of boot and the reduction attributable to the new investment obtained in the merger are clearly integrated steps in a single transaction and cannot properly be analyzed otherwise.

Not only are boot distributions and *Zenz* redemptions both steps in integrated transactions, but their characterization also presents the same ultimate issue. Either corporate distribution is entitled to sales rather than dividend treatment if its effect is to shift materially the ownership of the corporation to other stockholders. That much the Service seems to have conceded when it acknowledged that the principles of section 302 were applicable to boot characterization issues arising under section 356. In analyzing the *Zenz* redemption, it was observed that a reduction in corporate ownership resulting from a shift to new investors who had dealt solely with the corporation was entirely relevant to the characterization of corporate distributions. The character of that reduction is unaffected by whether the new investment is attributable to the purchase of stock from the corporation or a corporate combination. In either case, the old stockholders' proportionate interests in the continuing corporate entity have been reduced to the same extent. Thus, the reduction in proportionate interest caused by the merger is as relevant to the characterization of boot distributed in the merger as is the reduction in interest produced by new investment in a *Zenz* redemption.

However, an integrated transaction analysis of boot need not lead, as the Commissioner undoubtedly feared, to the unsatisfactory result reached in *McDonald v. Commissioner*. As in the event of a *Zenz* redemption, the measurement of a shift in proportionate interest is not simply a matter of comparing a stockholder's former holdings with the interest obtained in an altered and greatly expanded corporation. Rather,

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resulting corporation. See *infra* the discussion in the text accompanying notes 91-93. For the purpose of measuring this continuity, it is the established position of the Service that redemptions incident to the reorganization are to be taken into account, that is, integrated with the reorganization itself. Rev. Proc. 77-37, § 3.02, 1977-2 C.B. 568, *superseded in part*, Rev. Proc. 79-14, 1979-1 C.B. 496, *superseded*, Rev. Proc. 80-22, 1980-1 C.B. 654, *superseded*, Rev. Proc. 81-10, 1981-1 C.B. 647, *superseded*, Rev. Proc. 82-22, 1982-1 C.B. 469, *modified and superseded*, Rev. Proc. 82-60, 1982-45 I.R.B. 29 (Nov. 8). Similarly, in Revenue Ruling 75-360, 1975-2 C.B. 110, the Commissioner contended that a redemption should be integrated with a stock exchange for the purpose of determining whether a qualifying reorganization had occurred. The Commissioner under present policy thus is in the absurd position of arguing that the boot must be integrated for the purpose of testing for a reorganization but separated for the purpose of determining the character of the boot.

the relevant factor is the extent to which the stockholder has disposed of the old investment in a manner that accomplishes a shift of ownership. The reduction in proportionate ownership attributable to the corporate expansion is irrelevant to this question for the reasons stated in connection with the *Zenz* redemption: To this extent, the reduction in proportionate interest does not reflect a disposition. The calculation of the extent to which recipients of boot have diminished their continuing proportionate interest in their old investment should only be made with reference to the original value of that investment. Thus, after the transaction, a stockholder must be regarded as owning that proportion of his prior investment that the value of his post-reorganization holding bears to the value of his interest in the old corporation prior to the reorganization. Any further reduction in proportionate interest occasioned by the merger is irrelevant to the characterization of the boot.

The differences between these approaches can be illustrated using the facts assumed in Revenue Ruling 75-83: Corporation *X*, the 60 outstanding shares of which were owned by individual *A*, is acquired in a statutory merger by corporation *Y*, the 40 outstanding shares of which were equally owned by individuals *B*, *C*, *D*, and *E*. (It is assumed the value of an *X* share equals the value of a *Y* share.) In the merger, *A* receives 35 shares of *Y* stock plus boot of \$250x. Under its separate transaction approach, the Service treated *A*'s interest as merely changing from 60/60 to 35/35 for no reduction in proportionate interest at all, notwithstanding that *A* withdraws a substantial portion of his investment from corporate solution and owns only 35 of the 75 shares of *Y* stock outstanding after the reorganization. Under the court's analysis in *McDonald v. Commissioner*, *A*'s interest would be regarded as declining from 60/60 or 100 percent to 35/75 or 47 percent, the same result as would be reached under a literal application of Revenue Ruling 75-447 in an analogous *Zenz* redemption. Under the approach suggested here, *A*'s interest would be regarded as falling from 60/60 to 35/60 or 58 percent, a computed reduction that accurately reflects the extent of *A*'s disposition of his prior interest to *B*, *C*, *D*, and *E*. Quite plainly, the additional investment of the owners of the acquiring corporation should have no effect on the character of *A*'s disinvestment. Conversely, the shift in ownership actually produced by *A*'s disinvestment cannot properly be ignored as the Commissioner has proposed.

### **The Inadequacy of Current Solutions**

Before the Commissioner issued Revenue Ruling 75-83 formalizing the separate transaction approach to boot characterization, the Eighth Circuit was required to address the issue in a case that one can only wish



had not arisen when it did. Posing pathological facts that have unduly influenced subsequent authorities, *Wright v. United States*<sup>46</sup> probably has retarded the evolution of a proper rule for more typical cases. The taxpayer in *Wright* had owned a controlling interest in both of the corporations that were combined, F & G and World Wide. The corporations were consolidated into a newly formed survivor, Omni. Boot was issued to the taxpayer by the surviving corporation and was not allocated by the parties with respect to the stock of the predecessor corporations. Thus, the taxpayer exchanged his 99 percent interest in F & G and his 56 percent interest in World Wide for a 62 percent interest in Omni plus boot in the approximate amount of \$100,000.

Consistently with his later ruling, the Commissioner argued that the boot should be characterized independently for each constituent corporation and without regard to the change in ownership produced in the reorganization—the separate transaction approach.<sup>47</sup> The Commissioner initially suggested that the boot be treated as issued entirely in redemption of stock of F & G—a redemption which, if viewed separately from the reorganization, would yield only a de minimis change in ownership and thus dividend treatment. During the argument of the case, however, the government acknowledged that an allocation of the boot between F & G and World Wide might also be appropriate.<sup>48</sup>

The court rejected the Commissioner's separate and before analysis. It plainly believed that an approach that almost invariably produced dividend treatment to a dominant stockholder by ignoring the material change of ownership that occurred in the same transaction was not sensible.<sup>49</sup> On the other hand, the Court did not embrace the integration approach suggested by *McDonald v. Commissioner*, although this aspect of the court's opinion has been widely misunderstood.<sup>50</sup> Instead of

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<sup>46</sup> 482 F.2d 600 (8th Cir. 1973).

<sup>47</sup> *Id.* at 606. The Commissioner also argued, and the court agreed, that the principles of § 302 should be applicable in characterizing the boot. *Id.*

<sup>48</sup> *Id.* at 605–06. If all of the boot were treated as distributed by F & G, the taxpayer's interest would have been regarded as declining from 99.16% to 95.43%.

<sup>49</sup> The court rejected the separate and before approach urged by the Commissioner on the ground that it was an "artificial" reading of § 302 that ignored the continuation of the corporate entity. *Id.* at 608.

<sup>50</sup> The court never suggested, nor apparently did the taxpayer, that the initial 99% interest should be compared with the resulting 62% interest. However, in the only other modern appellate decision addressing the boot characterization issue, the court seemed to think that the court in *Wright* had used the *McDonald* approach. *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), criticized *infra* in text accompanying notes 63–68. See also Levin, Adess & McGaffey, *Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 Tax Law. 287 (1977). The authors approve of the *Wright* decision and clearly understand its holding but also appear to approve of the decision in *McDonald* and to regard that case as a precedent for the decision in *Wright*.

adopting either extreme method of characterization, the court developed a compromise approach, the form of which was quite likely influenced by the unusual facts before it. It held that the boot should be regarded as distributed by Omni, the surviving corporation, in exchange for the stock in Omni that would have been issued had there been no boot at all. Thus, the court compared the combined ownership interest of the taxpayer in the constituent corporations with his ownership interest in the same assets after the transaction.<sup>51</sup>

Several aspects to the compromise solution suggested in *Wright* must be examined separately. Arguably, the special problem of overlapping ownership, considered below, was the only issue addressed in *Wright*, for there is nothing in the opinion to suggest that the court was purporting to espouse a principle of boot characterization that would apply in the absence of the special facts of that case. Nevertheless, both the Commissioner and later cases involving boot characterization have speculated on how the rule of that case might be applied in the absence of overlapping ownership.

Applying the *Wright* principle to the example used above, A's interest is regarded as declining from the interest he would have received if no boot had been issued, 60/100, with his actual resulting interest, 35/75. The substantially disproportionate test of section 302(b)(2) is met because A's retained interest of 35/75 or 47 percent is 78 percent of his prior interest of 60 percent. Thus, relative to the approach suggested here, the *Wright* formula significantly understates the extent to which A's interest has been reduced and therefore is more likely to produce dividend treatment.<sup>52</sup>

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<sup>51</sup> In the district court the taxpayer had made the rather curious argument that the transfer of the stock of F & G and World Wide to Omni and the dissolution of the constituent corporations were separate transactions and that accordingly the taxpayer's exchange of stock was free of tax under § 351, rather than the reorganization provisions. Had that been the case, the boot would have been taxed at capital gains rates since that section lacks a dividend equivalence provision. Somewhat ironically, in view of his position on the characterization issue, the Commissioner prevailed on this point by demonstrating that the formation of Omni and the dissolution of the constituent corporations were steps in an integrated transaction. 72-2 U.S.T.C. (CCH) ¶ 9495 (E.D. Ark. May 24, 1972).

<sup>52</sup> The suggested approach, in contrast, makes it more likely that a redemption will meet the additional requirement of the substantially disproportionate test that the redemption leave the redeemed stockholder with less than 50 percent of the corporation's voting stock. I.R.C. § 302(b)(2)(B). This limitation is presumably applied when the rules of § 302(b) are borrowed for use under § 356. The before and after percentages are both lower under the *Wright* approach than under the approach advocated here. (In the example, they are 60 and 47 percent under *Wright* and 100 and 58 percent under the advocated approach.) The 50 percent limitation is thus more likely to be met if the *Wright* approach is used. The decline in proportionate interest is greater under the advocated approach, in con-

The reason for this difference is that like Revenue Ruling 75-83, the *Wright* formula is a separate rather than an integrated transaction approach. Rather than treating the boot distribution as occurring prior to the merger, as would Revenue Ruling 75-83, the *Wright* court viewed the distribution as occurring after the merger. Both approaches give effect to the change in ownership attributable to the boot distribution but not to the change in ownership produced by the merger. By treating *A*'s former interest as 60/100, the proportionate interest already diluted by the merger, the *Wright* approach eliminates that reduction in interest from the section 302(b)(2) computation. Accordingly, the *Wright* approach is objectionable for precisely the same reason as is the separate transaction approach of the Service which the court in *Wright* rejected.<sup>53</sup>

Although the Service has rejected the *Wright* approach in favor of its harsher separate and before analysis, *Wright* emerges as more favorable to a finding of dividend equivalence than the integrated approach endorsed by the Service in the analogous redemption context. Given the weakness of the Service's own separate transaction analysis, it may seem surprising that the Commissioner did not immediately embrace the reasoning of the *Wright* court. One explanation for this resistance may be that the Commissioner, with one fearful eye fixed on *McDonald v. Commissioner*, never understood *Wright*. Revenue Ruling 75-83, the Commissioner's response to the decision in *Wright*, initially illustrated his disagreement with an example in which there was overlapping ownership.<sup>54</sup> When reprinted in the *Cumulative Bulletin*, however, the example had been changed to assume a merger which lacked any overlap-

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trast, and the stockholder is thus more likely under this approach to meet the other requirement of the substantially disproportionate test—that his proportionate interest after the transaction be less than 80 percent of what it was before. I.R.C. § 302(b)(2)(C).

<sup>53</sup> Although mergers do not normally result in corporate contractions, the error of the *Wright* analysis can be seen quite clearly by comparing that approach with the *Zenz* integration approach of Revenue Ruling 75-447. Adjusting the facts of that ruling to the merger context, assume a target corporation with 100 shares of stock outstanding and equally owned by two stockholders is acquired by a corporation with 30 shares of stock outstanding and having the same value. In the merger, each stockholder in the target corporation receives 30 shares of acquiring corporation stock and boot of \$20x. Under the approach of Revenue Ruling 75-447, each of the target stockholders would be regarded as having reduced his interest from 50/100 to 30/90, thus retaining 67 percent of his investment. Under the *Wright* approach, however, each would be regarded as reducing his interest from 50/130 to 30/90. Under § 302(b)(2), this reduction from a 38% interest to a 33% interest, a retention of 87% of the prior investment, would be insufficient to escape dividend equivalence under the substantially disproportionate rule, contrary to the holding in Revenue Ruling 75-447.

<sup>54</sup> The original version of Revenue Ruling 75-83 is described in Levin, Adess & McGaffey, *supra* note 50, at 288 n.8. In that version, *A* owned all 60 shares of corporation *X* and 10 of the 40 shares of corporation *Y*.

ping ownership. In this merger, *A* exchanged all 60 of the outstanding shares of the target corporation, *X*, for 35 shares of the acquiring corporation, *Y*, a corporation in which *A* had previously had no interest, and boot of \$250x. *Y* had 75 shares outstanding after the merger. The ruling purports to illustrate the effects of the *Wright* decision on the facts of the ruling, stating that under *Wright* *A*'s interest would be regarded as reduced "from 60 shares of *Y* stock to 35 shares."<sup>55</sup> However, a proportionate change in interest cannot be computed unless the total shares of stock outstanding, the denominator of the fraction, are specified. Under the *McDonald* integration approach, *A*'s interest would be regarded as declining from 60/60 to 35/75, while under the *Wright* post-merger redemption approach, the interest would be regarded as declining from 60/100 to 35/75. On the assumed facts, either reduction satisfies the substantially disproportionate test of section 302(b)(2), and it thus is not fully clear how the Commissioner interpreted the *Wright* decision or which of the tests he was rejecting. Both interpretations, however, are inconsistent with the separate and before approach that the ruling clearly did adopt.

Since the analysis of the court in *Wright* was erroneous, the reasoning of the Commissioner in rejecting it might seem insignificant. However, in an attempt to discredit *Wright* while bolstering its own rather weak position, Revenue Ruling 75-83 sets forth an argument apparently meant to suggest that in characterizing reorganization boot, only the Commissioner's "separate and before" analysis is permissible. The argument, however, proves nothing of the kind.

The reasoning of Revenue Ruling 75-83 is not fully clear. While the Commissioner's separate and before test is plainly set forth, the ruling does not characterize its approach as a separate transaction approach and does not consider the alternative possibility of an integrated approach. Moreover, in the only analysis contained in the ruling, the Commissioner explains his disagreement with the decision in *Wright* solely in terms of the proper identification of the distributing corporation. The ruling contends, undoubtedly correctly, that boot must be regarded as distributed by the target corporation, whereas the court in *Wright* treated the distribution as made by the resulting corporation.<sup>56</sup> Thus, the ruling

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<sup>55</sup> 1975-1 C.B. at 113.

<sup>56</sup> The ruling states only that the court in *Wright* erred in distinguishing cases holding that "the amount of the dividend is measured by reference to the earnings and profits of the transferor," that is, the target corporation. Since the holding in *Wright* was that the distribution was not a dividend equivalent, there was no occasion for the court either to distinguish or follow cases concerning earnings and profits computations. However, the Commissioner's point was that the court erred in treating *Omni*, rather than *F & G* or *World Wide*, as the distributing corporation.

could be read as suggesting, not that boot lacks factual integration with the merger, but that the change in ownership produced by the merger is irrelevant to the characterization of boot. That is, it may be the position of the Commissioner that, even if the distribution of boot and the merger itself are steps in an integrated transaction, the implicit requirement of section 356 that the boot be treated as distributed by the target corporation also requires that the character of the boot be determined solely by reference to the stockholders of the target corporation. The change in ownership thus must be measured separately from and prior to the merger. However, the identity of the distributing corporation should not control the characterization issue.

In a boot characterization case, two quite separate questions are presented. One involves the computation of gain and, in the event of dividend equivalence, of earnings and profits, issues that depend on the identity of the stock with respect to which the distribution is made. The Commissioner's objection to *Wright* addresses these issues. The more important question in *Wright* and Revenue Ruling 75-83, however, is the manner in which the change in proportionate ownership is to be computed, whether under an integrated or a separate analysis and, if separate, whether before or after. It is not evident that the resolution of the first issue has any implication at all for the resolution of the second. Once the distributing corporation has been identified, the manner in which the change in ownership of that corporation is to be measured remains entirely open. Indeed, in the *Zenz* context, the identity of the distributing corporation is clear but that identity does not bar taking into account the change in ownership produced by the new investment.

If the reasoning of Revenue Ruling 75-83 has any relevance to the characterization issue, it is limited to a rejection of the exclusive focus in *Wright* on postreorganization holdings. There may be a conceptual tension between the use of the tax attributes of the target corporations for measuring gain while the distribution is characterized by reference to the holdings in the resulting corporation.<sup>57</sup> However, the reasoning

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As discussed below in the context of overlapping ownership, the Commissioner's position here is well founded. *See infra* notes 70-74 and accompanying text. At least in the absence of the peculiar facts presented in *Wright*, the tax consequences to stockholders liquidating a portion of their investment in the course of a reorganization should be determined solely by reference to the tax attributes of the investment being liquidated.

<sup>57</sup> While a tension may be conceded, it would not have been internally inconsistent for the court in *Wright* to resolve the characterization issue as it did, by treating the distribution as made by the resulting corporation, but to measure the taxpayer's gain by reference to the tax basis of his stock in the constituent corporations. Since the entire amount of the boot would have been subject to tax regardless of the identity of the distributing corporation, this issue was not material to the court's decision.

has no relevance to the choice between a separate and an integrated transaction approach. Under the integrated approach, it can readily be acknowledged that the target corporation is the distributor of the boot, but the ownership dilution produced by the merger still must be taken into account in testing for dividend equivalence. Indeed, in *McDonald*, the court and both parties assumed that the tax attributes of the target corporation rather than those of the acquiring corporation were controlling, even though the transactions were integrated for characterization purposes.<sup>58</sup> Accordingly, while the reasoning contained in Revenue Ruling 75-83 may somewhat discredit the particular test employed in *Wright*, it does not support the approach adopted by the Commissioner, nor does it constitute an objection to an integrated approach either of the *McDonald* type or of the type suggested here.

Since the publication of Revenue Ruling 75-83, only the Fifth Circuit has addressed the boot characterization issue. In view of the weakness of the Commissioner's position, it was somewhat surprising that the court in *Shimberg v. United States*<sup>59</sup> elected to adopt the same result. However, that court completely misunderstood the legal rules it was asked to apply, and its decision cannot be regarded as rational support for Revenue Ruling 75-83.<sup>60</sup>

*Shimberg* presented the boot characterization question in the traditional context. A relatively small corporation in which the taxpayer owned 66 percent of the stock was merged into a far larger company in a transaction which qualified as an A reorganization. The consideration received consisted of common stock of the acquiring corporation and substantial cash boot. The district court<sup>61</sup> correctly undertook to characterize the boot under section 356(a)(2) by applying the principles of section 302 as construed in *United States v. Davis*. In testing for the required "meaningful reduction" of proportionate interest, the court em-

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<sup>58</sup> 52 T.C. at 86. Although in *McDonald* the distribution was treated as a redemption rather than as a boot distribution, there was no suggestion that the redemption should be treated as made by the acquiring corporation rather than the target corporation.

<sup>59</sup> 577 F.2d 283 (5th Cir. 1978).

<sup>60</sup> In a subsequent Fifth Circuit decision in which the characterization of the boot did not affect the amount of tax due, the court commented favorably on the *Shimberg* opinion. *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980). The principal issue posed by *General Housewares* was the fascinating but quite complex question of whether a transaction may be both a reorganization and a liquidation. In holding that the transaction before it could be both, the court relied heavily on the reduction in continuing ownership interest by the stockholders of the target corporation from a 100 percent interest to a less than one percent interest in the acquiring corporation. On the boot characterization issue, the court quite inconsistently commented favorably on its rejection of such an integrated approach in *Shimberg*.

<sup>61</sup> 415 F. Supp. 832 (M.D. Fla. 1976).

ployed a *McDonald*-type analysis. It concluded that a reduction of ownership from 66 percent to less than one percent had occurred and that the boot did not have the effect of a dividend.<sup>62</sup>

In an entirely unsatisfactory opinion, the Fifth Circuit reversed. The court seemed to believe that the comparison made by the district court was inseparable from the section 302 meaningful reduction test.<sup>63</sup> Since the court understandably did not believe that the results produced by that comparison were reasonable, it quite amazingly refused to apply the *Davis* test. The court declined to follow the decision in *Wright* because that court had also applied the meaningful reduction test. Apparently, the Fifth Circuit did not understand that the court in *Wright* had not applied the test in the same way as the district court. Instead, the court concluded that any pro rata distribution of boot in a reorganization had the effect of a dividend—thereby virtually returning to the completely discredited 1945 decision in *Commissioner v. Estate of Bedford*.<sup>64</sup> The taxpayer contended that the distribution was not pro rata because of the change in ownership produced by the reorganization, citing such cases as *Zenz v. Quinlivan*, but the court rejected that line of authority because it had arisen under section 302 and the court had already determined that it would not apply the tests of that section.<sup>65</sup> Instead, the court held that the distribution should be viewed as if made in a separate transaction prior to the reorganization. Since such a distribution would not have altered the proportionate interests of the stockholders, the court found that the distribution had the effect of a dividend. The court referred to the legislative history of the Revenue Act of 1924<sup>66</sup> which introduced the predecessor to section 356(a)(2). That history, the court said, provided an example of a situation in which dividend treatment was stated to be appropriate in “virtually the same fact situation” as the case before the court.<sup>67</sup> In fact, the example reproduced by the court involved a merger into a shell corporation which presumably would not have produced any change in ownership interest.<sup>68</sup>

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<sup>62</sup> *Id.* at 836.

<sup>63</sup> 577 F.2d at 288.

<sup>64</sup> 325 U.S. 283 (1945). Evidently aware of the harshness of its holding, the Court noted that while the automatic dividend rule had applied to all boot distributions, its rule applied only to pro rata distributions. 577 F.2d at 290. Both approaches are identical, however, in their simplistic effort to apply a fixed rule without regard to material differences in the effect of the distributions.

<sup>65</sup> 577 F.2d at 290 n.18.

<sup>66</sup> H.R. REP. No. 179, 68th Cong., 1st Sess. 14 (1924), reprinted in 1939-1 (part 2) C.B. 241, 252.

<sup>67</sup> 577 F.2d at 289.

<sup>68</sup> Even those commentators who favor the approach of Revenue Ruling 75-83 have acknowledged the “shortcomings” of the *Shimberg* opinion. See Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations*, 31 CASE W.

The existing authority on the characterization of boot represents an extreme failure of analysis. Both the Commissioner and the two circuit courts that have addressed the issue concluded, with ample justification, that the integration approach suggested by *McDonald v. Commissioner* was unreasonably favorable to avoiding dividend equivalence. A thoughtful examination of the *McDonald* analysis would have disclosed that it produced unreasonable results because it improperly gave effect to fresh investment that expanded the corporate entity. Once the irrelevance of such investment is recognized, its effect can be eliminated from the computation of the decline in proportionate interest, thereby yielding a reasonable boot characterization that is consistent with the analysis of the closely analogous *Zenz* redemption.

### Overlapping Ownership

A stockholder receiving boot in a reorganization who owns stock in both of the constituent corporations is a distinct source of confusion in the analysis of the boot distribution. The stockholder's interest is both reduced by the merger and the boot distribution and increased by the interest he holds in the second corporation. The question, then, is the relevance of this second interest to the characterization of the partial liquidation of the first investment. If there is a single satisfactory answer to this question, it is neither simple nor very tidy. Before demonstrating how the principles employed above might be applied to overlapping stockholdings, it will be profitable to review why the solutions thus far proposed are erroneous.

The added fact that one or more stockholders of the target corporation also own stock in the acquiring corporation cannot alter the propriety of an integrated transaction approach. Thus, the solutions suggested in Revenue Ruling 75-83 and in the *Wright* case—the only appellate decision to have considered the character of boot in a reorganization involving both overlapping ownership and a significant change in ownership resulting from the merger<sup>69</sup>—remain wrong for the reasons stated above.

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RES. L. REV. 1, 34 (1980), where the author agrees with the statement in Revenue Ruling 75-83 that a distribution of boot should be taxed as a dividend if the distribution would have been so taxed in the absence of a reorganization. However, neither he nor the ruling explains why the change in ownership attributable to the reorganization should be ignored when such a change is taken into account in analogous *Zenz* transactions.

<sup>69</sup> *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), also involved the reorganization of two corporations in which there was substantial overlapping ownership. However, because the transaction did not change proportionate interests, the distribution incident to the reorganization clearly was not entitled to sales treatment.



The *Wright* decision, however, contains a further error that is peculiar to overlapping stockholdings. In *Wright*, it may be recalled, the court blended the taxpayer's two investments, treating them as one, and characterized the boot distribution by reference to the aggregate disinvestment. Moreover, the court treated the boot as distributed by the newly formed resulting corporation in exchange for its stock, rather than as a disposition of the stock of the constituent corporations. The Commissioner, both before the court in *Wright* and in Revenue Ruling 75-83, contested each of these elements in the court's analysis. To that extent, the Commissioner was clearly correct.

At the stockholder level, a reorganization is merely an exchange of one corporate investment for another which would be a taxable exchange<sup>70</sup> but for the nonrecognition provisions of the Code.<sup>71</sup> Under those provisions, a stockholder's gain on an exchange is taxed only to the extent that he receives boot in addition to stock in the surviving corporation. If a tax is imposed on the receipt of boot, it is a tax on gain realized upon the exchange of stock in the target corporation for stock in the acquiring corporation.<sup>72</sup> Both in fact and in the contemplation of the reorganization provisions of the Code, the stock disposed of is the stock of the target corporation. Like a simple redemption, boot in a reorganization may more nearly resemble either the proceeds of a sale or the distribution of a dividend and thus can be taxed as either.<sup>73</sup> Regardless of how the

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<sup>70</sup> See, e.g., *Marr v. United States*, 268 U.S. 536 (1925), arising prior to the enactment of the reorganization provisions. There have been occasional suggestions, not generally accepted, that a nonstatutory form of reorganization may exist. See *Weiss v. Stearn*, 265 U.S. 242 (1924). See also *Telephone Answering Serv. Co. v. Commissioner*, 63 T.C. 423 (1974), reviewed (3 dis.), *aff'd*, 39 A.F.T.R. 2d (P-H) ¶ 77-786 (4th Cir. Nov. 8, 1976), *cert. denied*, 431 U.S. 914 (1977). Under the existing statutory pattern, such decisions are probably best viewed as an expansive construction of the F reorganization. See *infra* note 87.

<sup>71</sup> For corporate reorganizations, the principal sections affecting stockholders are §§ 354, 355, and 356. The Code contains several other nonrecognition provisions that operate similarly, including tolerances for taxable boot. See e.g., I.R.C. §§ 1031 through 1039.

<sup>72</sup> Under § 1001, gain or loss is realized on the exchange of stock in the target corporation. When § 356 requires that "the gain" be recognized, in the event of boot, it is the realized gain to which the section refers. See BITTKER & EUSTICE, *supra* note 13, at ¶ 14.34.

<sup>73</sup> The stockholder has exchanged his interest in the target corporation for an interest in the acquiring corporation—the equivalent under the tax law to a sale. But in a merger, or practical merger under § 368(a)(1)(C), the two forms of acquisitive reorganization in which boot is permitted, the acquiring corporation becomes the continuation of the target corporation as part of the same transaction. Thus, the stock has been "sold" to the corporation in which the stockholder has an interest, the equivalent of a redemption. If that "redemption" does not produce a material change in proportionate interest, § 356(a)(2) requires that it be taxed as a dividend.

boot is characterized, however, it remains a liquidation of a portion of the stockholder's prior investment, and the tax consequences of the distribution must be determined by reference to the tax attributes of the constituent corporation in which he was a stockholder.<sup>74</sup>

In the absence of overlapping stock ownership, the foregoing is not questioned.<sup>75</sup> However, the mere fact that one or more stockholders of the target corporation may also own stock in the acquiring corporation does not alter the analysis. Dating back to the earliest decided cases,<sup>76</sup> the taxing system has with surprising rigor recognized the corporate entity as separate not only from its individual stockholders<sup>77</sup> but also from other corporations under common control.<sup>78</sup> Thus, an investment in one

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<sup>74</sup> When boot is taxed as the proceeds of a sale, it is quite clear that the stock is the stock in the target corporation. However, when the boot is to be taxed as a dividend, the Code is somewhat less clear concerning whether the dividend is to be deemed distributed by the target or the acquiring corporation. Both § 356(a)(2) and the regulations thereunder require taxation as a dividend to the extent of the earnings and profits of "the corporation." Nevertheless, in the absence of overlapping ownership, commentators and practitioners alike have uniformly assumed the more logical answer that the distributing corporation is the one in which the recipient of the boot previously held an interest. See, e.g., BITTKER & EUSTICE, *supra* note 13, at ¶ 14.34; Vrooman, *Corporate Acquisitions—(A) Reorganization*, TAX MGMT. (BNA) No. 77-3d, A-27 (1974). The question has not been much addressed by the courts and when Revenue Ruling 75-83 asserted this position, it could only adduce scant authority. *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Commissioner v. Owens*, 69 F.2d 597 (5th Cir. 1934); *Ross v. United States*, 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959).

<sup>75</sup> When the distribution of boot is taxable as a dividend and both the target and the acquiring corporations are controlled by the same stockholder, the Commissioner has been reluctant to permit the taxpayer's choice of target corporations to control the earnings and profits limitation on dividend treatment. On such facts, the Commissioner has taken the rather dubious position that both corporations should be regarded as transferors and thus that the earnings and profits of both could be used to support dividend taxation. Rev. Rul. 70-240, 1970-1 C.B. 81. While that argument was accepted in *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), it has more recently been rejected as inconsistent with the structure of § 356. *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir.), *cert. denied*, 449 U.S. 836 (1980); *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970), *reviewed* (2 dis.). *Wright* appears to be the only case in which boot entitled to sales treatment was deemed attributable to a disposition of stock of the acquiring corporation.

<sup>76</sup> *Eisner v. Macomber*, 252 U.S. 189 (1920), was partially based on this principle.

<sup>77</sup> *Moline Properties v. Commissioner*, 319 U.S. 436 (1943). For current applications of this principle, see *Foglesong v. Commissioner*, 621 F.2d 865 (7th Cir. 1980), *appeal filed* (Feb. 16, 1982); *Strong v. Commissioner*, 66 T.C. 12 (1976), *reviewed, aff'd*, 1977-1 U.S.T.C. (CCH) ¶ 9240 (2d Cir. Feb. 14, 1977).

<sup>78</sup> The rigidity of this doctrine has led to several specific statutory modifications. See, e.g., I.R.C. §§ 267, 304, 482, and 1239. This latter section is illustrative. While assuming that, in general, such transactions are to be respected in accordance with their form, under a recent expansion of § 1239, sales of depreciable

corporate entity is entirely separate from an investment in a second, and transactions affecting one such investment cannot properly be offset by transactions involving a second. No one would assert, for example, that a dividend from one wholly-owned corporation could be offset by an investment in a second, thereby exonerating the stockholder from tax on the distribution. Similarly, a reduction in proportionate ownership of one corporation cannot be offset by an expanded interest in a second, even if these shifts in investment occurred as parts of the same transaction. Yet, that is precisely the effect of the commingling of the stockholdings that occurred in *Wright*.

The netting approach used in *Wright* measures only a fictitious change in ownership that does not reflect the stockholder's disinvestment in either of the constituent corporations. In fact, if boot is distributed with respect to the stock of both constituent corporations in a consolidation such as occurred in *Wright*, the stockholder's disinvestment in one corporation may justify sales treatment even if the disinvestment in the second does not. Yet the commingling approach taken in *Wright* conceals these different degrees of disinvestment and thus erroneously imposes a single characterization upon a fictitious aggregation.<sup>79</sup>

Accordingly, the Commissioner was correct in arguing in *Wright* that the consequences of the distribution of boot must be measured separately with respect to the stockholdings in each of the constituent corporations. He was also correct in asserting in Revenue Ruling 75-83 that the distribution must be regarded as a disposition of the stock of the target corporation in exchange for a distribution from that corporation. The Commissioner was in error, however, in further asserting that the characterization of that distribution could be made without taking into account the change in stockholdings produced by the merger.

In taking an integrated transaction approach to the characterization of boot in this context, the overlapping stockholdings should neither be taken completely into account nor completely ignored. It arguably fol-

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property between two corporations, 80 percent or more of the stock of which is owned by the same taxpayer, are denied capital gains treatment.

<sup>79</sup> This effect of the *Wright* approach can be seen by assuming that individual *B* owns 60 of 80 shares in corporation *X* and 10 of 50 shares in corporation *Y*. In a consolidation, boot is distributed only to *B* in exchange for 25 of her *X* shares and boot is also distributed to the *Y* stockholders pro rata in exchange for one half of their stock. Under the *Wright* commingling approach, *B*'s interest would be regarded as changing from 70/130, or 54% to 40/80, or 50%. Since that decline is not significant, *B* would undoubtedly receive dividend treatment under *Wright*. However, *B*'s interest in the *X* assets has in fact declined from a 75% interest to a 50% interest, a shift in interest to the other stockholders of *Y* that should entitle *B* to sales treatment. On the other hand, her interest in the assets of *Y* has increased, and therefore, the boot distributed to her with respect to the *Y* stock should receive dividend treatment.

lows from the foregoing objections to the decision in *Wright* that the continuing investment in the acquiring corporation is entirely irrelevant to the characterization of the disinvestment in the target corporation. That is, the mere retention of the investment in the acquiring corporation should neither diminish nor enhance the extent of the disposition of the investment in the target. On the facts of the first version of Revenue Ruling 75-83, in which *A* owned all 60 shares in the target corporation and ten of 40 shares in the acquiring corporation and received boot in exchange for 25 of his 60 shares, his holdings in the target might be regarded as reduced from 60/60 to 35/60, just as in the absence of overlapping ownership.

The result is neither obviously reasonable nor obviously unreasonable in this and most other factual combinations. In some situations, however, this result is plainly wrong. Assume *S* owns 90 of 100 shares of stock, all having the same value, of each of the target and acquiring corporations and causes the distribution of boot in exchange for 50 shares in the target corporation. Under this analysis, *S*'s interest would be deemed to decline from 90/100 to 40/100, thereby assuring *S* of sales treatment. Nevertheless, it is intuitively obvious that *S* did not significantly reduce her proportionate ownership in the corporation or in the surviving corporation, in which she owns 130 of 150 shares or 87 per cent.

Evidently, the overlapping holdings must to some extent be taken into account in measuring the stockholder's continuing interest. However, the overlapping holdings cannot simply be added to the stockholder's remaining holdings in the target corporation. Assume *F* owns 60 of 100 shares in the target corporation and 25 of 1000 shares in the acquiring corporation, the shares are of equal value, and *F* receives boot of \$25x in exchange for 25 of his shares in the target. If *F*'s original holdings in the acquired were merely added to his remaining holdings in the target, he would be regarded as retaining his entire investment, notwithstanding the boot distribution. His interest would be regarded as changing from 60/100 before to  $(60 - 25 + 25)/100$  after, or unchanged. This is plainly wrong. In the absence of any overlapping stockholdings, *F* would have been regarded as having substantially reduced his proportionate interest from 60/100 to 35/100, and would have been entitled to sales treatment. It would be unreasonable if his ownership of a nominal interest in the acquiring corporation produced more than a nominal change in his computed ownership. On these facts, a result reasonable in appearance could be produced by applying the *Wright* formula, but that approach is wrong in principle and on other facts produces unreasonable results.

The basic premise of this article is that in computing a change in

ownership, the retained ownership must be compared with a value no greater than the value of the prior investment because it is only with respect to that value that a disposition has occurred. It was observed that a sale of stock at the corporate level resembles a sale at the stockholder level only to this extent and that further fresh investment is irrelevant. The denominator of the fractions that measure the proportionate interests after the reorganization thus includes the fresh investment only to the extent it replaces the investment withdrawn by the exchanging shareholders as boot. To the extent that this fresh investment is attributable to the overlapping stockholdings in the acquiring corporation by the recipient of the boot distribution, the stockholder should be treated as retaining that proportion of his prior investment. Thus, the numerator of the fraction for each shareholder should include that fraction of the shareholder's interest in the acquiring corporation that equals the ratio of the replacing fresh investment to the entire value of the acquiring corporation.

Assume *A*, who owned 60 of the 100 outstanding shares of the target, exchanges 35 of them for shares of the acquiring corporation of equal value and 25 for boot of \$25x. The other shareholders of the target exchange stock for stock only. *A* owned ten of the 40 shares of the acquiring corporation previously outstanding. The denominator of the fraction depicting *A*'s postreorganization interest is 100, representing the value of the target remaining after the boot distribution (\$75x) and \$25x attributable to the fresh investment by the acquiring corporation, amounting to 25/40 of that fresh investment. The numerator of the fraction must be similarly determined to be 41.25, the sum of 35, the investment of *A* in the target which continues into the acquiring corporation, plus 6.25, which represents *A*'s 25 percent interest in 25/40 of the acquiring corporation.

This analysis produces quite reasonable results in both of the examples used earlier. *F* owned 60/100 of the target and 25/1000 of the acquiring corporation and received a boot distribution in exchange for 25 shares of the target. Intuitively, it appeared that *F* should be regarded as continuing to hold just slightly more than 35/100 and should have been entitled to sales treatment. Under the suggested analysis, *F* would be regarded as retaining those 35 shares plus 25/1000 of the retired 25 shares, or 0.625 shares. In the other example, *S* owned 90/100 of each corporation and received boot for 50 shares of the target. Under this analysis, she would be regarded as retaining 40 shares in the target corporation plus 90/100 of the 50 shares exchanged for boot. Thus, her interest would be regarded as declining from 90/100 to  $(40 + .9 \times 50)/100$ , or 85/100. The formula thus accurately reflects her nominal decline in ownership and would produce dividend treatment.

This solution to the problem of overlapping ownership is admittedly somewhat complex and cannot be derived from the simple formula contained in section 302(b)(2). That section, however, does not address the effect of simultaneous fresh investment. On the other hand, this solution can be derived from an understanding of the nature of a transaction involving a shift of investment and of the relevance of fresh investment to that transaction. Indeed, the proper solution to the characterization of boot in the presence of overlapping ownership could not be obtained in any other manner. Moreover, obtaining a reasonable solution to this complex question, through the consistent application of the principles and analyses suggested here, provides a further indication of the validity of these suggestions.

### Redemption of Acquiring Corporation's Stock

On occasion, it is the stockholders of the acquiring corporation rather than those of the target corporation who wish to withdraw a portion of their investment in connection with an acquisitive reorganization. The choice of the corporate entity that will survive the merger or other reorganization is largely arbitrary.<sup>80</sup> While a variety of tax and nontax factors may bear on the decision, the corporation that survives is often simply the one whose management originated the merger proposal. The stockholders of the target and acquiring corporations thus stand in an identical relationship to the resulting entity. Nevertheless, because the stockholders of the acquiring corporation do not exchange their stock for stock of another corporate party to the reorganization, the provisions that determine the tax consequences of the receipt of stock and boot in a reorganization do not apply to the stockholders of the acquiring corporation.<sup>81</sup> Section 302, not section 356(a)(2), governs distributions of property incident to a reorganization to these stockholders.<sup>82</sup>

As a result, a rather nice question is presented by a partial redemption of stock of the acquiring corporation. Since section 302 applies, presumably the *Zenz* integration doctrine and the principles of Revenue Ruling 75-447 also apply, and the change in stockholdings is computed taking into account the change in ownership attributable to the merger. It seems just too absurd, however, to apply one set of rules to stockholders of the acquiring corporation and another to the stockholders of

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<sup>80</sup> For this reason, it has been suggested that in a reorganization, both corporations and their stockholders should be treated alike. See, e.g., Turner, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CAL. L. REV. 902 (1976). However, they are not.

<sup>81</sup> Reg. § 1.354-1(a).

<sup>82</sup> See Rev. Rul. 77-415, 1977-2 C.B. 311.

the target corporation when each group suffers an identical change in its relationship to the continuing corporate entity.

The nice question is just another demonstration that Revenue Rulings 75-83 and 75-447 are inconsistent.<sup>83</sup> At the moment, the Commissioner seems willing to tolerate the inconsistency. In at least one private ruling, the Commissioner has applied the integration doctrine of Revenue Ruling 75-447 to a redemption of stock from stockholders of an acquiring corporation, and concluded that a substantially disproportionate redemption occurred.<sup>84</sup> Interestingly, as a result of the combination of the merger and redemption in this ruling, the size of the acquiring corporation remained unchanged, and the transaction did not include a distribution of boot to stockholders of the target corporation. The nicer absurdities of these rulings are yet to be fully illuminated.

### Characterizing the Reorganization Itself

It is argued here that the present rules for the taxation of corporate distributions accompanying new investment are inadequate. Because those who fashioned the rules have not focused on the proper relevance of the new investment to the distribution, the rules have not given the new investment proper effect. Under Revenue Ruling 75-447, new investment is excessively influential in the event of a corporate expansion through a *Zenz* transaction while, in characterizing boot, neither the courts nor the Service has given sufficient weight to the investment. Having established an approach to analyzing fresh investment, a somewhat more ambitious attempt can now be made to demonstrate that, in a more complex version of the same shift in investment, the courts have also not given proper weight to new investment in fashioning the tax consequences to withdrawing stockholders.

The shifting of investment addressed herein can be accomplished

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<sup>83</sup> Since the choice of the corporation to survive the merger can frequently be controlled by the parties, the inconsistency of these approaches may permit the taxpayers to elect between sales or dividend treatment. See Horwood, *Clarified IRS Position Enhances Planning For Stock Redemptions With New Shareholders*, 46 J. TAX'N 338 (1977). Not only is it undesirable for taxpayers to be able to so manipulate their tax liabilities, it is also undesirable for such quirks in the taxing system to influence the form of business transactions.

Levin, Adess & McGaffey, *supra* note 50, at 298-99, point out that under the *Wright* approach, which they favor, boot distributed to stockholders of the target is characterized in the same way regardless of which corporation is selected as the target. However, since *Wright* is not consistent with Revenue Ruling 75-447, distributions to the target stockholders are still characterized differently from distributions to stockholders of the acquiring corporation.

<sup>84</sup> LTR 8009108 (Dec. 10, 1979).

through a variety of corporate manipulations. One of the more common is a liquidation-reincorporation, a form of transaction which itself can be executed in a variety of ways. An old corporation can be completely liquidated and a portion of its assets contributed to a new corporation formed by the stockholders of the old together with the new investors. Alternatively, the old corporation can purport to sell a portion of its assets to the new corporation and then liquidate completely.<sup>85</sup> In either case, the old stockholders withdraw a portion of their investment from corporate solution but continue as stockholders with their proportionate interest diluted by the new investment. Although the net effect of the transaction is identical to the more simple *Zenz* redemption, not even the most idealistic student of income taxation would suggest that a liquidation-reincorporation can routinely be recast as a *Zenz* redemption.<sup>86</sup> The analogy may be apt, but there are competing analogies and principles of broader application—such as the integrity of the corporate entity—are at stake.<sup>87</sup> While the liquidation-reincorporation will be addressed under a different set of rules, the relevance of fresh investment to the characterization of the disposition of an old investment is the same under any set of rules.

The parties to such a transaction seek to achieve far more than capital gains taxation of the net proceeds retained by the old shareholders. If the steps are respected in accordance with their form as separately taxable transactions, the shareholders of the old corporation recognize all

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<sup>85</sup> For a fuller discussion of the variants of liquidation-reincorporation transactions, and of the tax consequences sought by the parties, see Hjorth, *Liquidations and Reincorporations—Before and After Davant*, 42 WASH. L. REV. 737, 740–44 (1967).

<sup>86</sup> However, on appropriate facts, the Commissioner has disregarded a statutory merger and treated the overall transaction as a simple redemption. LTR 8025110 (Mar. 28, 1980).

<sup>87</sup> While the new corporation may appear to be the mere continuation of the old, it is in fact a separate legal entity and is so recognized by the taxing system. See *supra* notes 77–78 and the accompanying text. Tax attributes of the old corporation carry over to the new only if a reorganization has occurred. See I.R.C. §§ 358 (stockholder's basis), 362 (corporate basis), and 381 (other carryovers). Thus, the liquidation-reincorporation transaction normally cannot be reconstructed as a mere redemption. The suggestion occasionally surfaces in the case law and published rulings that a corporation can be a mere continuation of another, without reference to the statutory reorganization provisions. See, e.g., *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir.), *cert. denied*, 305 U.S. 605 (1938); *Telephone Answering Serv. Co. v. Commissioner*, 63 T.C. 423 (1974), *reviewed* (3 dis.), *aff'd*, 39 A.F.T.R. 2d (P-H) ¶ 77-786 (4th Cir. Nov. 8, 1976), *cert. denied*, 431 U.S. 914 (1977); Rev. Rul. 68-349, 1968-2 C.B. 143. The suggestion is probably wrong but if valid, would amount to the assertion of a nonstatutory form of reorganization having wholly unarticulated parameters. Therefore, even a "mere continuation" would involve the application of a set of rules far more complex than would a simple redemption.



gain or loss inherent in their shares. Offsetting this, the new corporation takes a basis for the reincorporated assets equal to their fair market value, and the tax attributes of the old corporation, particularly its earnings and profits account, disappear. However, all of these objectives are lost if the overall transaction is a reorganization within the meaning of section 368(a)(1). In that event, the property retained by the old stockholders is boot, which may have the effect of a dividend, and the tax attributes of the old corporation, including the basis of its assets, carry over to the new corporation. In the first instance, then, the character of the corporate distribution incident to a liquidation-reincorporation transaction is a function of whether the transaction is a reorganization.

At first glance, the proper definition of a corporate reorganization appears quite removed from the issues considered thus far—the characterization of corporate distributions in redemptions and reorganizations. At the level of technical statutory analysis, the issues are indeed quite different. At the level of income tax policy, however, the issues are strikingly similar, except that the reorganization definition focuses attention on the shareholders of the old corporation as a group rather than individually as was previously the case. Thus, the question previously addressed was whether the characterization of a distribution to a particular stockholder should be affected by fresh investment obtained as a part of the same transaction. In the present context, the question is whether the characterization of a transaction (in the form of a liquidation-reincorporation) as a mere continuation of investment pursuant to the reorganization provisions or as a termination of that investment should be affected by the presence of fresh investment. In both contexts, the greater the significance accorded to fresh investment, the greater is the likelihood that the shareholder will have sales treatment.

By virtue of the wealth of detail, statutory and interpretative, accompanying the definition of a reorganization, a wide variety of events may cause a liquidation-reincorporation transaction to be regarded as sufficiently altering the character of the old shareholders' investment interest to preclude reorganization characterization. That definitional detail, however, is not of present interest. It is assumed that the liquidation-reincorporation transactions examined comply with all requirements for reorganization treatment except those pertaining to the question here addressed: the extent to which fresh investment alone can properly cause what would otherwise be characterized as a reorganization to be treated instead as a disposition subject to capital gains taxation.

Over the surprisingly weak objections of the Commissioner, relatively sparse case law has established the proposition, now widely accepted, that the mere addition of fresh investment to a liquidation-reincorporation transaction causes the transaction to fall outside the scope of the

reorganization provisions of the Code. That is, in this context, fresh investment alone can convert a mere continuation of an incorporated investment into a termination of that investment, taxed as a sale. The granting of such extreme significance to fresh investment is inconsistent not only with the present rules governing *Zenz* redemptions and boot distributions but also with the rule suggested here. The consequence of this faulty analysis of fresh investment is that taxpayers willing to take this more circuitous route can obtain far more favorable income tax consequences for their distributions of corporate profits than can be obtained through the financially identical *Zenz* redemption. If the relevance of fresh investment to the characterization of the transaction were evaluated properly, the consequences of the liquidation-reincorporation would be virtually identical to the *Zenz* redemption.

### **The Proper Relevance of Fresh Investment: Continuity of Interest Test**

Aside from the statutory detail, a transaction is a reorganization if the investment of the stockholders of an old corporation is continued into a new one in a form insufficiently altered to warrant, as a matter of tax policy, the imposition of tax. A finding that a transaction is not a reorganization thus implies that the investment has been so changed that the transaction should be treated as a disposition of the prior investment. The characterization of the transaction is made on an overall basis, addressing the change in the form of the investment of the old stockholders as a group.<sup>88</sup> From the earliest cases arising under the reorganization provisions, the courts have been attentive to this fundamental character of a reorganization and have actively undertaken to limit reorganization treatment to transactions that, in substance, produced continuations of the prior investment. Independently of the statutory definition, the courts have evolved a judicial conception of the essence of a reorganization and

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<sup>88</sup> The wisdom of extending nonrecognition treatment to individual stockholders as a function of the continuity of interest by the stockholders as a group has recently been questioned by the American Law Institute. ALI, *FEDERAL INCOME TAX PROJECT* (Tent. Draft No. 1, 1977) (Corporate Acquisitions (except for Special Limitations on Loss Carryovers)). Moreover, the study proposes to eliminate the continuity of interest test for reorganization treatment and disconnect the consequences of a corporate combination at the corporate level from the consequences at the stockholder level. For discussions of these proposals, see Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 *TAX LAW.* 743 (1980); Wolfman, "Continuity of Interest" and the *American Law Institute Study*, 57 *TAXES* 840 (1979). The suggested downgrading of the continuity test is not inconsistent with the treatment of fresh investment suggested herein.

have insisted that a transaction conform to that conception before allowing reorganization treatment, notwithstanding that the transaction meets the literal requirements of the statutory definition.<sup>89</sup>

One result of these judicial efforts has been the continuity of interest doctrine, which requires that the old stockholders as a group retain a "definite and substantial" proprietary interest in the affairs of the continuing corporation.<sup>90</sup> The continuity of interest doctrine serves a function in the reorganization definition similar to the function of section 302 in the taxation of redemptions. The doctrine defines the reduction in the continuing interest of the prior stockholders that is deemed so substantial as to require that their exchange be taxed as a sale. Obviously, the results of this measurement are different under the reorganization provisions than they are under section 302. The reorganization provisions require that the overall transaction be characterized as either a reorganization or a taxable transaction. That characterization has implications with respect to the holdings of all parties to the transaction. Under section 302, by contrast, the determination characterizes only the redemption distribution. Notwithstanding these differences in the significance of the determinations under the continuity of interest doctrine and section 302, both sets of rules apply an essentially identical approach to the definition of a disposition.

The standard formulation of the continuity test, now contained in Revenue Procedure 77-37,<sup>91</sup> is that continuity of interest is present if the stockholders of the target corporation acquire stock in the acquiring corporation "which is equal in value, as of the effective date of the reorganization, to at least 50 percent of the value of all of the formerly outstanding stock of the [target] corporation as of the same date." Continuity, therefore, is a function of the extent to which the stockholders of the target corporation have retained their prior investment. Their continuing interest has always been measured with respect to the value of that investment immediately prior to the reorganization.

In so measuring the continuity of interest retained by the old stock-

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<sup>89</sup> In addition to the continuity of interest test, early decisions established the requirement that a reorganization serve a business purpose and applied a step transaction analysis for determining whether the spirit, as well as the form, of the statutory requirements had been met. See *Helvering v. Elkhorn Coal Co.*, 95 F.2d 732 (4th Cir.), *cert. denied*, 305 U.S. 605 (1938); *Helvering v. Gregory*, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

<sup>90</sup> The doctrine originated in the early decisions in *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), and *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). The ultimate form of the requirement was fashioned in *LeTulle v. Scofield*, 308 U.S. 415 (1940). See generally BITTKER & EUSTICE, *supra* note 13, at ¶ 14.11.

<sup>91</sup> § 3.02, 1977-2 C.B. 568.

holders, fresh investment attributable to the acquiring corporation is entirely relevant.<sup>92</sup> Without this fresh investment, there would be no change in the ownership of the target corporation as a result of corporate distributions incident to the transaction and no occasion to question the continuity of ownership. The corporation might contract and the proportionate interests in the corporation might shift among the old stockholders but, absent new investment or direct sales of stock to new investors, the old stockholders as a group would retain complete ownership of the resulting corporation. Therefore, to the extent that fresh investment obtained in a reincorporation produces a result that is the functional equivalent of a direct sale of stock at the shareholder level, that investment creates a discontinuity of interest. However, fresh investment attributable to the acquiring corporation which has the effect of expanding the resulting corporate entity beyond the preacquisition size of the target is wholly irrelevant to the test and, thus, to the characterization of the reorganization.<sup>93</sup> As a result, the proportionate interests of the old stockholders in the resulting corporation are not relevant. A reorganization remains free of tax and is not treated as a disposition even if the old stockholders convert their 100 percent interest in the target into an insignificant fractional interest in the acquiring corporation.

While the formulation of the continuity of interest test in Revenue Procedure 77-37 is entirely appropriate in the context of acquisitive reorganizations resulting in corporate expansions, the context in which the rule was fashioned, it must be modified to accommodate corporate contractions, which typically occur in liquidation-reincorporations. In any such transaction in which the old stockholders withdraw from corporate solution an amount exceeding 50 percent of the net worth of the target corporation, the test as formulated by Revenue Procedure 77-37 is not met. Even in the total absence of fresh investment, a pro rata distribution of liquid assets incident to a reincorporation thus may cause the transaction to fail the continuity of interest test under this formulation and to be treated as a complete liquidation. Since the old stockholders have retained complete ownership of their incorporated investment in this case, the result is plainly wrong. A mere distribution not accom-

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<sup>92</sup> More generally, any transfer of an ownership interest from the old stockholders of the target corporation to a new owner is relevant to the continuity of interest test. Thus, discontinuity can also be produced by a direct sale of stock by a target stockholder, incident to the reorganization, whether to the acquiring corporation or to an outsider to the transaction. *See* Rev. Proc. 77-37, 1977-2 C.B. 568. Whether a sale is factually related to the reorganization can pose a difficult question. *See* *McDonald's, Inc. v. Commissioner*, 76 T.C. 972 (1981), *rev'd*, 688 F.2d 520, (7th Cir. 1982).

<sup>93</sup> *See, e.g., Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *General Housewares Corp. v. United States*, 615 F.2d 1056 (5th Cir. 1980).

panied by any shift in proportionate interest does not amount to a disposition; reorganization treatment is clearly appropriate.

Neither the Commissioner nor the courts have applied this traditional formulation of the continuity of interest doctrine to a corporate contraction incident to a liquidation-reincorporation transaction. In Revenue Ruling 61-156,<sup>94</sup> in which the Commissioner set forth his basic position with respect to such transactions, the net worth of the resulting corporation was approximately one third of the value of the liquidated predecessor. Stockholders of the old corporation obtained 45 percent of the stock of the new corporation while new investors acquired 55 percent. Although the ruling does not expressly define the continuity of interest test that it applied, it treats the old shareholders as retaining a 45 percent continuity of interest which, the ruling concludes, was sufficient to permit reorganization characterization. Similarly, in the two cases in which the Commissioner has asserted that liquidation-reincorporations were F reorganizations, notwithstanding the presence of fresh investment, the transactions produced substantial corporate contractions.<sup>95</sup> While in both cases reorganization treatment was denied, in neither did the court suggest that the absence of continuity of interest was a factor in the decision.<sup>96</sup>

Consistently with the measurement of the continuing proportionate interest of a stockholder following a simple redemption, in a reorganization resulting in a corporate contraction, continuity must be measured with respect to the value of the continuing corporate entity. Continuity of interest is present in such a case if the stockholders of the old corporation emerge from the transaction owning at least 50 percent of the stock of the resulting corporation, giving full effect to any fresh investment.

This continuity of interest test takes fresh investment into account, for the purpose of determining whether a disposition should be taxed as a sale, in exactly the same manner as it is suggested here that section 302 should take fresh investment into account, for the same purpose, in connection with a *Zenz* redemption or a boot distribution. To the extent

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<sup>94</sup> 1961-2 C.B. 62.

<sup>95</sup> *Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); *Gallagher v. Commissioner*, 39 T.C. 144 (1962), *acq.*, *reviewed* (3 dis.).

<sup>96</sup> A corporate contraction commonly occurs in a recapitalization constituting a reorganization under § 368(a)(1)(E). In that context, the courts and the Commissioner have agreed that continuity of interest is not broken merely because a majority of the stock is exchanged for debt. However, this result has been achieved, not by recognizing that a modification of the continuity doctrine must be made for corporate contractions, but by asserting that the doctrine does not apply to E reorganizations. See *Hickok v. Commissioner*, 32 T.C. 80 (1959), *nonacq.*, 1959-2 C.B. 8, *nonacq. withdrawn*, 1977-2 C.B. 3; Rev. Rul. 77-415, 1977-2 C.B. 311.

that the old stockholders shift their ownership of the old corporation to new investors through the combined effect of a corporate distribution and fresh investment, but only to that extent, the fresh investment is relevant to the characterization of the transaction.

If a corporate combination meets this continuity of interest test, the presence of fresh investment should not be a ground for denying reorganization treatment. The relevance of fresh investment to the reorganization definition is given full effect in the continuity of interest doctrine; the investment has no greater relevance.

Fresh investment is not given any greater relevance in an acquisitive reorganization or *Zenz* transaction. An acquisitive reorganization which passes the continuity of interest test is not barred from reorganization treatment regardless of the further level of fresh investment that may be obtained. There is no reason for a different approach to fresh investment in the context of an F reorganization than is applied by the courts to an acquisitive reorganization or to an analogous *Zenz* redemption. Fresh investment alone is not reflective of a disposition and does not alter the character of a reincorporation any more than it alters the character of an acquisitive reorganization or a *Zenz* redemption.

Nevertheless, the courts have attached a significantly greater importance to fresh investment in the definitions of the nondivisive D and the F reorganizations. While that greater importance may arguably have been required by the specific statutory requirements for the nondivisive D reorganization, its significance to the F reorganization is entirely of judicial manufacture. In so exalting the importance of fresh investment in the definition of the F reorganization, the courts committed a clear error which allows taxpayers to obtain far different tax consequences upon a shift in investment executed pursuant to a liquidation-reincorporation than pursuant to a *Zenz* redemption.

### **Historical Treatment of Liquidation-Reincorporations**

The statutory definitions of the several categories of reorganizations have become excessively technical and complex. Fortunately for present purposes, little of that technicality is of interest. Broadly speaking, three types of reorganizations are recognized by section 368: acquisitive,<sup>97</sup>

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<sup>97</sup> Acquisitive reorganizations are described in §§ 368(a)(1)(A), (B), and (C) as including, respectively, statutory mergers and consolidations, stock acquisitions, and asset acquisitions, including countless hybrids and variations. For such reorganizations, the statutory requirements are quite technical and precise. For that reason, only the most extraordinary failure of planning could cause a liquidation-

divisive,<sup>98</sup> and merely formal.<sup>99</sup> If a liquidation-reincorporation transaction is to be a reorganization, it must fall within the last category, specifically the nondivisive D or F reorganization.

### *The D Reorganization*

In the earliest efforts to impose reorganization treatment on these transactions, the Commissioner relied upon the nondivisive D.<sup>100</sup> That provision, however, together with the provisions of section 354 with which the distribution must comply, imposes an impressive series of prerequisites to reorganization treatment, which, if applied at all literally, would have made the nondivisive D a useless weapon against the liquidation-reincorporation.<sup>101</sup> It requires that a "corporation" transfer "substantially all"<sup>102</sup> of its assets to another corporation and then distribute

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reincorporation transaction to fall within the definition of one of the acquisitive reorganizations.

<sup>98</sup> Divisive reorganizations are endorsed by one of the two categories of reorganizations described in § 368(a)(1)(D). The D reorganization contemplates the formation of a corporate subsidiary, but then requires that the stock of the subsidiary be distributed to the stockholders of the parent in a manner that complies with either § 354 or § 355. A divisive reorganization is one in which the distribution complies with § 355; that can only occur if after the transaction two or more corporations exist and are actively engaged in business. I.R.C. § 355(b)(1). Thus, the transactions in question normally cannot be a divisive D reorganization.

<sup>99</sup> In addition to the two reorganizations discussed in the text, § 368(a)(1)(E) treats a recapitalization as a reorganization. However, since that provision appears limited to the recapitalization of a single corporation, a reincorporation cannot normally be an E reorganization. See BITTKER & EUSTICE, *supra* note 13, at ¶ 14.17.

A reincorporation may encompass not only a shift in investment but also an alteration in the nature of the securities retained by the old stockholders. In that event, before nonrecognition treatment can be imposed upon the transaction, it may need to be regarded as an E reorganization and another form of formal reorganization. That necessity creates considerable confusion for, in a startling and quite off-hand passage in an early opinion, the Supreme Court once remarked that to obtain reorganization treatment, a transaction must consist of only one of the formal changes. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942). Thus, if the transactions combined two immaterial changes, it could not be a reorganization. While the logic of that limitation is elusive at best and the Service has announced its disagreement with the Court (Rev. Rul. 61-156, 1961-2 C.B. 62), it remains uncertain what result would be reached by the Supreme Court today. The requirement of only one formal change per transaction may remain as a technical limitation upon the treatment of the transaction in question as a reorganization.

<sup>100</sup> Baker, *Recent Developments in the Service's War Against Liquidation-Reincorporations*, 49 J. TAX'N 82 (1978). See also Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964).

<sup>101</sup> Hertzog, *The Reincorporation Problem in Subchapter C: A Question of Semantics?*, 9 WM. & MARY L. REV. 928, 930-31 (1968).

<sup>102</sup> I.R.C. § 354(b)(1).

all of its property, including the stock or other property received in exchange for its assets, to its stockholders "in exchange" for their stock in the old corporation.<sup>103</sup> Moreover, these stockholders must then "control" the newly formed corporation by owning at least 80 percent of the voting power of its outstanding stock and 80 percent of the number of all nonvoting shares outstanding.<sup>104</sup>

From the very beginning, however, the courts adopted extremely liberal constructions of the requirements of the nondivisive D when they were needed to impose reorganization treatment upon what appeared a mere reincorporation of the predecessor corporation. The transfer of as little as 15 percent of the assets of the old corporation has been regarded as "substantially all" when these assets permitted the continuation of the old business.<sup>105</sup> The requirement that the old corporation distribute all of its property has in effect been waived, the court treating the retained property as constructively distributed and reinvested.<sup>106</sup> Similarly, the predicate for nonrecognition at the stockholder level, an exchange of securities, has been ignored when the stockholders received the stock of the new corporation directly upon its formation.<sup>107</sup>

On the other hand, the courts, almost uniformly, have been unwilling to introduce any degree of flexibility in the requirement that the old stockholders must control the new corporation. No decision has found a D reorganization where over 20 percent of the stock of the new corporation was owned by persons who had not been stockholders in the old corporation or closely related to these stockholders.<sup>108</sup> In general, the Commissioner does not appear to have seriously argued that a D could be found on such facts. In *Gallagher v. Commissioner*,<sup>109</sup> the first case arising under the 1954 Code to present such facts, the Commissioner

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<sup>103</sup> I.R.C. § 368(a)(1)(D).

<sup>104</sup> I.R.C. § 368(c).

<sup>105</sup> *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981). See also *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967).

<sup>106</sup> *Grubbs v. Commissioner*, 39 T.C. 42 (1962), *reviewed*.

<sup>107</sup> *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981); *James Armour, Inc. v. Commissioner*, 43 T.C. 295 (1964), *appeal dismissed*.

<sup>108</sup> Although the stock attribution rules of the Code are not applicable to the reorganization provisions in general or to the 80 percent requirement of § 368(a)(1)(D) in particular, the Commissioner has succeeded in two relatively recent cases in persuading a court to find a D reorganization although over 20 percent of the stock of the new corporation was owned by persons who were not stockholders of the old corporation but were related to the continuing stockholders. *Ringwalt v. United States*, 549 F.2d 89 (8th Cir.), *cert. denied*, 432 U.S. 906 (1977) (Clifford trust); *Stanton v. United States*, 512 F.2d 13 (3d Cir. 1975) (wife). For an earlier decision to the contrary, see *Breech v. United States*, 439 F.2d 409 (9th Cir. 1971).

<sup>109</sup> 39 T.C. 144 (1962), *acq.*, *reviewed* (3 dis.).



specifically declined to assert the application of the D reorganization. Three years later, the argument was made in *Berghash v. Commissioner*,<sup>110</sup> but only in a relatively weak form and as a secondary argument. It is far from clear why the Commissioner and the courts, which had shown such creativity in avoiding the other statutory requirements for a D reorganization, lapsed into such literalism in the face of fresh investment. The substantive distortion of the statutory description of the D reorganization that would result from a relaxation of the requirement of 80 percent control would be no greater than the distortion that occurred in relaxing the requirements that the old corporation transfer substantially all of its assets to the new corporation and that it distribute all of its remaining assets to its stockholders in exchange for their stock. It can be inferred that the courts, and possibly the Commissioner, perceived that the addition of fresh investment possesses a substantive importance that could not be brushed aside, that fresh investment is not compatible with a formal reorganization.<sup>111</sup>

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<sup>110</sup> 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966). The Commissioner placed reliance upon the finding of an F reorganization under the approach set forth in Revenue Ruling 61-156, 1961-2 C.B. 62, discussed *infra* in text accompanying notes 112-117.

<sup>111</sup> There is some support for the suspicion that the Commissioner was at least equivocal regarding the relationship between fresh investment and the nonacquisitive reorganizations in the Commissioner's contemporaneous, and perhaps continuing, attitude towards the divisive D reorganization. While the Commissioner was somewhat reluctantly arguing that fresh investment perhaps ought not destroy a nondivisive D reorganization, he was quite clearly asserting that fresh investment should destroy a divisive D.

It sometimes happens that an acquiring corporation in a contemplated acquisitive reorganization does not wish to take all of the assets of the target company. One solution is to segregate the unwanted assets into a separate corporate entity which is distributed to the stockholders of the target company prior to the acquisition in what the taxpayers characterize as a tax-free, divisive D reorganization. For many years, the Commissioner took the position that a subsequent acquisitive reorganization involving either the old corporation or its newly distributed subsidiary would destroy the tax-free character of the divisive reorganization for the stated reason that divisive and acquisitive reorganizations were inherently incompatible. See *Commissioner v. Morris Trust*, 367 F.2d 794, 799-800 (4th Cir. 1966). Although the illogic of the Commissioner's position did not prevail, and this limitation of the divisive D has now been somewhat eroded, his litigating position with respect to the divisive D reorganization was plainly inconsistent with a liquidation-reincorporation analysis.

Moreover, the Commissioner apparently continues to adhere to a strict application of the control requirement for a divisive D reorganization. When the corporate division involves a preexisting subsidiary, the transaction need only comply with the distribution requirements of § 355 and does not have to be a D reorganization. I.R.C. § 355(a)(2)(C). In that situation, the Commissioner will not attack an acquisitive reorganization involving either the old parent or the old subsidiary. See, e.g., Rev. Rul. 75-406, 1975-2 C.B. 125. Nor will the Commissioner attack an acquisitive reorganization involving the distributing corpora-

*The F Reorganization*

Rather than confront this statutory limitation on the use of the D reorganization, the Commissioner turned to the F reorganization. Early case law, however, had suggested that this type of reorganization, described in section 368(a)(1)(F) as a "mere change in identity, form, or place of organization, however effected," was of very narrow scope.<sup>112</sup> Perhaps for that reason, the Commissioner has not argued that such a reorganization can include the obtaining of fresh investment by a continuing corporation. Rather, in Revenue Ruling 61-156,<sup>113</sup> the Commissioner adopted the position that even though fresh investment was obtained contemporaneously with a reincorporation and as a part of a single overall plan, the investment could nevertheless be regarded as a "separate transaction" from the reincorporation.

The ruling addressed a transaction in which an existing corporation formed a shell corporation to which it transferred all of its assets in exchange for stock and notes of the shell and cash obtained through a borrowing. Immediately following this reincorporation, the old corporation was liquidated, and the new corporation made a public issue of its stock, leaving the old stockholders with a 45 percent interest in the new corporation and the new investors with 55 percent. The ruling divided the transaction into three components: the public offering, the reincorporation and the recapitalization, and the distribution. The analysis of the relationships among these components was vague at best. The ruling asserted that the fresh investment could be "disregarded as being a separate transaction" in analyzing the balance of the transaction because the "dominant purpose" of the transaction was to withdraw funds from a continuing corporate entity and that purpose was achieved without the stock issuance. The ruling contained no facts to support its characterization of the dominant purpose of the transaction, except that the amount of the distribution to the old stockholders exceeded the amount of the fresh

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tion following a D reorganization. *See, e.g.*, Rev. Rul. 68-603, 1968-2 C.B. 148; Rev. Rul. 70-434, 1970-2 C.B. 83. However, to date, the Commissioner has not endorsed the acquisition of a distributed corporation, newly formed in a D reorganization. Rather, the Commissioner appears to take the position that such an acquisition would violate the control requirement of a D reorganization, thus destroying the D and possibly converting the acquisitive reorganization into a taxable transaction. *See* Rev. Rul. 70-225, 1970-1 C.B. 80. *See generally* Handler, *Variations on a Theme: The Disposition of Unwanted Assets*, 35 TAX L. REV. 389 (1980). The anomaly so produced seems less reflective of principle than of technical construction.

<sup>112</sup> In *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202-03 (1942), the Supreme Court had stated that "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of incorporation.'"

<sup>113</sup> 1961-2 C.B. 62.

investment. It thus was unclear whether the Commissioner was referring to particular, undisclosed facts of the transaction in question or was suggesting that such a purpose, and thus separation, could always be inferred from a reincorporation transaction resulting in a corporate contraction. In the former case, which seems unlikely, the ruling would not be of general significance. In the latter, the analysis is flatly inconsistent with other applications of the step transaction doctrine. Most particularly, the ruling, under the latter reading, is contrary to the *Zenz* integration doctrine which the Commissioner has fully accepted and repeatedly extended.<sup>114</sup>

The separate treatment of the fresh investment, the ruling concluded, permitted the treatment of the balance of the transaction as an "(E) and (F)" reorganization "coupled with a withdrawal of funds."<sup>115</sup> The ambiguous word "coupled" likely reflects the Commissioner's uncertainty about the separate character of that aspect of the transaction. While the ruling concluded that the distribution was separate from the reorganization, it contained no independent reasoning with respect to the issue and merely contained the non sequitur that "viewing the issuance of stock . . . as a transaction separate from the reorganization, it is concluded that the distribution" should be treated as a separate dividend taxable under section 301.<sup>116</sup>

While the analysis contained in Revenue Ruling 61-156 is thus somewhat obscure, the Commissioner seemed to be asserting that the two corporate actions were lacking a sufficient identity of purpose and interdependence to be treated as factually related. By negative implication the ruling thus appeared to concede the relevance of fresh investment to the characterization of the transaction and the incompatibility of fresh investment and a formal reorganization occurring as parts of the same transaction. With this concession, reorganization treatment was precluded unless the Commissioner was able to persuade a court that the investment and the reincorporation were factually unrelated.

In two cases arising shortly after the publication of Revenue Ruling 61-156, the Commissioner was unable to persuade the Tax Court of this.<sup>117</sup> Consequently, the court concluded that far more had occurred than a mere shift in the place of incorporation and that the transaction could not be considered an F reorganization.

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<sup>114</sup> When Revenue Ruling 61-156 was issued, the *Zenz* doctrine had not been expanded to its present scope. However, the Commissioner has yet to refine the approach taken in the 1961 ruling.

<sup>115</sup> 1961-2 C.B. 62, 63.

<sup>116</sup> *Id.* at 65.

<sup>117</sup> *Berghash v. Commissioner*, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); *Gallagher v. Commissioner*, 39 T.C. 144 (1962), *acq.*, *reviewed* (3 dis.).

### Inadequacy of Current Law

As a result of relatively slim case law, the characterization of corporate distributions incident to a liquidation-reincorporation has come to be controlled by the level of fresh investment attracted as a part of the transaction.<sup>118</sup> Transactions that otherwise would be regarded as possessing a sufficient continuity of investment interest to be treated either as non-divisive D or as F reorganizations are instead treated as taxable dispositions of the prior investment in the presence of fresh investment. As a result, corporate distributions by way of a purported corporate dissolution are automatically eligible for favorable capital gains taxation rather than being subjected to the more discriminating tests of section 302, applicable to redemptions or reorganization boot.

This is plainly in error, as can be demonstrated by examining the factual circumstances presented in *Gallagher v. Commissioner*.<sup>119</sup> In a classic liquidation-reincorporation, five stockholders of the old corporation who owned 62 percent of its stock formed a new corporation which purchased the assets of the old. The five stockholders acquired 72 percent of the stock of the new corporation and the balance was acquired by seven employees of the company. In the liquidation of the old corporation, approximately \$400,000 was distributed to stockholders who did not participate in the new company and \$670,000 was distributed to the five continuing stockholders, of which \$220,000 was reinvested in the new corporation. The new investors contributed a total of \$82,000 for their stock.

The *Gallagher* transaction could as easily have been accomplished by a *Zenz* redemption in which the stockholders of the old corporation caused all or a portion of their stock to be redeemed and the corporation sold new stock to its employees. Since the corporation did not expand as a result of the new investment, Revenue Ruling 75-447 properly would be applicable to the characterization of the distributions to the continuing stockholders. Since four of the five continuing stockholders increased their proportionate interests in the corporation, the distributions to them would fail the substantially disproportionate test and most likely would be found to be dividend equivalents. One continuing stockholder reduced his proportionate interest from 21 percent to ten percent and he, along with those completely terminated, would have been entitled to sales treatment.

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<sup>118</sup> Notwithstanding the relative paucity of authority, the commentators have generally assumed that the courts will not find an F reorganization when material new investment is present. See, e.g., BITTKER & EUSTICE, *supra* note 13, at ¶ 14.54.3; Hjorth, *supra* note 85, at 759-60; Lane, *supra* note 100, at 1248-49.

<sup>119</sup> 39 T.C. 144 (1962), *acq.*, reviewed (3 dis.).

If the transaction had been found to be a reorganization, comparable tax consequences would have obtained. The old stockholders would have been taxed only on the cash boot distributed to them. As demonstrated earlier, the proper characterization of the boot would parallel the characterization that would be imposed in a *Zenz* redemption and consistent results thus would be obtained with respect to these two forms of functionally equivalent transactions. The effects of the transaction at the corporate level would also parallel the consequences of a *Zenz* redemption. The tax attributes of the old corporation, including its earnings and profits<sup>120</sup> and the basis for the assets remaining in corporate solution,<sup>121</sup> would be preserved, while the basis of assets acquired with the newly contributed cash would equal the full value of those assets. Thus, in a reorganization, the income tax consequences to each of the parties would be appropriately tailored to the financial effect of the transaction upon each of them. For that reason, the finding of a reorganization, where appropriate, will normally produce superior tax results than will the contrary finding.

By contrast, the failure of the court in *Gallagher* to find a reorganization produced quite different results. The continuing stockholder who substantially reduced his interest recognized all gain inherent in his stockholdings, notwithstanding that a portion of that investment was not, in substance, withdrawn from corporate solution. The remaining four stockholders also obtained capital gains taxation despite their increased proportionate interests. *Gallagher* suggests that as long as the new investors acquire more than 20 percent of the stock of the new company, sales treatment is achieved even if all of the stockholders of the old corporation continue in the new corporation, their proportionate interests do not change materially, and the net distribution retained by them is wholly pro rata.<sup>122</sup>

### Prospects for a Judicial Solution

Although the early judicial construction of the F reorganization seemed to establish a narrow and technical scope for the provision, it is clear that the significance so extended to fresh investment was not only wrong in principle but also produced wrong substantive results to the parties to the transaction. There is some evidence in the more recent cases in which the scope of the F reorganization has been considered that

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<sup>120</sup> I.R.C. § 381(c)(2).

<sup>121</sup> I.R.C. § 362(b).

<sup>122</sup> Indeed, the effect of the *Gallagher* approach on such a reincorporation would be to impose a moratorium upon dividend treatment not unlike the results of applying Revenue Ruling 75-447 literally to a corporate expansion.

the courts are beginning to recognize that the earlier approach was erroneous and that in the future fresh investment may be accorded a more appropriate significance.

In several cases, beginning with *Davant v. Commissioner*,<sup>123</sup> the courts have held that corporate distributions, even if resulting in material shifts in proportionate ownership, did not destroy what would otherwise be an F reorganization because the distributions were irrelevant to the characterization of the transaction. In *Davant*, the Fifth Circuit held that the combination of two corporations under common control accompanied by a distribution (found to be the equivalent of a dividend) of \$900,000 constituted an F reorganization. With little hesitation, the court concluded that the mere distribution of unneeded cash did not alter the character of the transaction as a mere change in form within the meaning of the reorganization provisions. Later that year, the same court, in *Reef Corp. v. Commissioner*,<sup>124</sup> found a reincorporation was an F reorganization, notwithstanding that the holders of 48 percent of the stock of the old corporation were completely redeemed as a part of the transaction. The court reasoned that neither the reincorporation nor the redemption effected a sufficient change in the character of the continuing investment to deny reorganization treatment and that the combination of these two corporate actions should not produce a different result. While the reasoning of the court in *Reef* is not compelling—the whole may, contrary to the court's view, exceed the sum of its parts—the Fifth Circuit correctly perceived that a shift in proportionate ownership was not relevant to the characterization of a reincorporation.

Significantly, the court in *Reef* also observed that it might have reached a different conclusion “if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation.”<sup>125</sup> The court appeared to be suggesting that an F reorganization might properly be found in the presence of any shift in proportionate ownership which does not violate the continuity of interest doctrine.

This suggestion in *Reef* was subsequently repeated by the Second Circuit in a case posing similar facts. In *Aetna Casualty and Surety Co. v. United States*,<sup>126</sup> the court examined a transaction designed to eliminate minority stockholders who owned 38 percent of the stock of a subsidiary corporation of the corporate taxpayer. The parent corporation formed a

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<sup>123</sup> 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). The holdings in some of these cases have subsequently been limited by statutory amendment. See note 128 *infra*.

<sup>124</sup> 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

<sup>125</sup> *Id.* at 137.

<sup>126</sup> 568 F.2d 811 (2d Cir. 1976).

new shell subsidiary, merged the existing subsidiary into the shell, and caused the issuance of parent company stock to the minority stockholders. The court concluded that the transaction was an F reorganization, notwithstanding what it characterized as the redemption of over 38 percent of the stock of the reorganized corporation. The court specifically stated that the redemption of a minority of the stockholders of a corporation as part of a reincorporation transaction was not inconsistent with F reorganization treatment.

The court noted that the prohibition against shifts in proprietary interest in connection with F reorganizations derived from a "broad dictum" in the opinion of the Supreme Court in *Helvering v. Southwest Consolidated Corp.*<sup>127</sup> While *Southwest* had involved the virtual elimination of the stockholders of the old corporation in an insolvency reorganization, in the case at hand "there was merely a shift in the proprietary interest of the minority stockholders." Having thus deprecated the restrictive prior decisions, the Second Circuit noted its agreement with the Fifth Circuit that while the traditional continuity of interest doctrine was applicable to the F reorganization, fresh investment not violating that rule should not destroy an F reorganization.

While the full import of this line of decisions cannot now be known, they demonstrate at the very least that the courts no longer regard themselves as bound by the narrow and inflexible construction of the F reorganization that influenced the decision in *Gallagher*. Moreover, these two circuits have clearly held that corporate action which is undertaken simultaneously with a reincorporation, but is not relevant to the characterization of that transaction, can be ignored in testing for the presence of an F reorganization. While both cases involved shifts in interest attributable to corporate distributions, no reason appears for treating shifts in ownership attributable to fresh investment differently. Indeed, language from the opinion in *Reef*, quoted by the Second Circuit, suggests as much. It seems reasonable, therefore, to conclude that the congressional formulation of the definition of the F reorganization does not preclude the judicial construction of that provision consistently with the general principles governing the finding of a reorganization. Under such a construction, fresh investment not violating the continuity of interest doctrine is irrelevant to the characterization of a liquidation-reincorporation.<sup>128</sup>

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<sup>127</sup> *Id.* at 823 n.15.

<sup>128</sup> The application of the F reorganization to liquidation-reincorporation transactions has been somewhat limited by the addition in 1982 of the requirement that the reorganization be "of one corporation." Pub. L. No. 97-248, § 255(a), 96 Stat. 324 (1982). The amendment was intended to prohibit F reorganization treatment of a combination of two or more operating companies, such as occurred in

### Characterization of Distributions

If a liquidation-reincorporation is deemed a reorganization, the amounts retained by the stockholders should be characterized under the reorganization rules. That is, the net amount retained should be viewed as a distribution by a continuing corporation to its stockholders in exchange for a portion of their stock in connection with a reorganization. It would appear that this amount should thus be treated as boot in a reorganization, its character determined in the same manner as in other boot distributions. Under the approach to boot characterization suggested above, the boot would be characterized under the same tests that are applicable to the characterization of redemptions. Thus, the consequences to a participant in a liquidation-reincorporation would parallel the consequences to a participant in a *Zenz* redemption.

In Revenue Ruling 61-156, however, the Commissioner appeared to adopt a contrary view. The ruling held that a liquidation-reincorporation was a reorganization. The retained assets, however, were not treated as boot. Rather, they were characterized as though they had been distributed to the stockholders in a distribution separate from the reorganization. The ruling did not consider the possibility that such a separate distribution might be a redemption taxable under section 302 but instead asserted that the distribution was taxable as a dividend under section 301.

For present purposes, it is unnecessary to address the still open question of whether distributions incident to an F reorganization constitute boot taxable under section 356 or are to be taxed outside of the reorganization provisions.<sup>129</sup> Regardless of the ultimate resolution of this doubt,

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*Aetna Casualty & Surety Co. v. United States*, 568 F.2d 811 (2d Cir. 1976), which otherwise constitutes another form of reorganization but is categorized as an F rerorganization solely for the purpose of obtaining the more favorable limitations on net operating loss carrybacks available under § 381(b). See CONF. REP. NO. 760, 97th Cong., 2d Sess. 540 (1982). There was no suggestion that the amendment was designed to restrict the use of the F reorganization in attacking liquidation-reincorporations, although such a restriction appears unavoidable. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), for example, involved the combination of two operating companies and presumably could not be regarded as an F reorganization under the amendment. Moreover, taxpayers may now be well advised to operate both the old and the new corporation for a period of time before combining all operating assets in the new corporation and dissolving the old. While the more transparent of such schemes should not avoid F characterization, the Commissioner's technical problems in securing reorganization treatment for liquidation-reincorporation transactions plainly have been increased under the amendment.

<sup>129</sup> Compare *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), with *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970), *reviewed* (2 dis.).



the effect of the fresh investment should be the same. In 1961, when the ruling was issued, dividend treatment of the distribution may have appeared appropriate because the automatic dividend rule was then applied to boot in reorganizations and it was entirely unclear whether the *Zenz* integration doctrine was applicable to partial redemptions. Today, however, it is clear that whether a distribution is regarded as boot incident to a reorganization or as a discretely taxable event, it is taxed as a sale if, as in the ruling, it occurs as part of a transaction in which the proportionate ownership of the old stockholders is reduced from 100 percent to 45 percent.

If the distribution constitutes reorganization boot, it should be taxed in the manner set forth in the earlier section of this article on boot. Conversely, if the distribution is regarded as separate from the reorganization exchange, it nevertheless is a distribution in exchange for a portion of the recipient's interest in the continuing corporation and should be tested for dividend equivalence under the rules of section 302. There is no basis whatsoever for avoiding the application of that section simply because the redemption assumed the form of a distribution in complete liquidation. Indeed, even in *Gallagher*, the court construed the Commissioner's argument in favor of taxation under section 301 as an assertion that the distributions failed the tests of section 302 and for that reason were to be taxed under section 301.<sup>130</sup> The more recent cases finding an F reorganization have assumed that distributions to minority stockholders whose interests were terminated constituted redemptions taxable as sales.<sup>131</sup> If distributions incident to an F reorganization can be redemptions taxable as sales pursuant to the complete termination rule of section 302(b)(3), no reason appears why a distribution cannot be similarly taxed under the substantially disproportionate rule of section 302(b)(2). Indeed, the notion that the consummation of an F reorganization should bar sale treatment for a concurrent redemption, thereby producing a harsher tax than would be imposed on distributions occurring in the absence of the reorganization, is the nonsensical result obtained under the now discarded automatic dividend rule. Since the dividend characterization contained in the 1961 ruling is presumably derived from that rule, it too should now be discarded. Accordingly, whether the distribution is taxable under section 302 or under section 356, the tax consequences to the parties to a liquidation-reincorporation can be made consistent with the conse-

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<sup>130</sup> 39 T.C. at 155. See also Hertzog, *supra* note 101, at 945-47. The author suggests that the government would have improved its chances of victory in *Gallagher* and *Berghash* if it had conceded the application of § 302.

<sup>131</sup> *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967). See also *Casco Prods. Corp. v. Commissioner*, 49 T.C. 32 (1967), *reviewed* (5 dis.).

quences that would be obtained if they had chosen to structure their transaction as a *Zenz* redemption.<sup>132</sup>

## Conclusion

The more favorable treatment that taxpayers have obtained in liquidation-reincorporations than in redemptions has been attributable to the difficulty that the Service and the courts have experienced in attempting to quantify the effect of fresh investment on the characterization of formal reorganizations. Instead of directly addressing the relevance of fresh investment to the finding of a reorganization, the Commissioner sought victory by manipulating the definition of the relevant transaction—the same unsatisfactory approach later adopted to obtain a favorable characterization of boot. When his unpersuasive separate transaction approach was rejected, the Commissioner lost his most effective weapon against the liquidation-reincorporation device. That defeat, in turn, led the Commissioner to press his attack through far less rational theories which, had they succeeded, would have materially disrupted the coherence of subchapter C.<sup>133</sup>

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<sup>132</sup> Complete consistency, however, would not be obtained. A *Zenz* redemption can presumably occur, although the old stockholders emerge with stock having a value far less than 50 percent of the value of the old corporation. If the transaction were structured as a liquidation-reincorporation, that radical a shift in ownership would violate the continuity of interest test, thereby precluding reorganization treatment.

<sup>133</sup> From as early as *Gallagher v. Commissioner*, 39 T.C. 144 (1962), *acq.*, *reviewed* (3 dis.), the Commissioner has argued that even if a liquidation-reincorporation transaction did not amount to a reorganization, capital gains taxation should be denied because the transaction also was not a complete liquidation within the meaning of § 331. That argument was accepted by the Tax Court in *Telephone Answering Serv. Co., v. Commissioner*, 63 T.C. 423 (1974), *reviewed* (3 dis.), *aff'd*, 39 A.F.T.R. 2d (P-H) ¶ 77-786 (4th Cir. Nov. 8, 1976), *cert. denied*, 431 U.S. 914 (1977), and *Casco Prods. Corp.*, 49 T.C. 32 (1967), *reviewed* (5 dis.). The court seemed relatively untroubled that its decisions in these cases determined what tax consequences were not available to the parties but gave not the slightest clue as to what tax consequences were available. The appellate courts have not concurred in this approach. For example, in *Aetna Casualty & Surety Co. v. United States*, N. 128 *supra*, the Second Circuit disapproved the reasoning in *Casco* and stated that the transaction was an F reorganization. 568 F.2d at 822 n.13.

More recently, the Commissioner has argued that the formation of a new corporation and the transfer of assets to it could be combined into a § 351 transaction. That argument has had little success in the courts. *See, e.g., Stevens Pass, Inc. v. Commissioner*, 48 T.C. 532 (1967). However, the Commissioner has recently expanded this attack. Under Revenue Ruling 78-294, 1978-2 C.B. 141, the transaction described in Revenue Ruling 61-156 might now be regarded as a § 351 exchange. Section 351, a nonrecognition provision closely related to the reorganization sections, is a poor second choice as the vehicle for attacking the

It is suggested here that the rules which emerge from a proper understanding of the relevance of fresh investment to the disposition of an interest in a corporation lead to a result that is both correct and reasonable. And, of perhaps greater importance, the consistent application of these rules yields consistent treatment for comparable but quite differently structured transactions, thus furthering the rationality and coherence of the Code.

### Epilogue

Three types of transactions have been considered. While they are structured quite differently, they have identical financial effects upon the parties involved. Moreover, the transactions are frequently viewed by taxpayers as alternative routes to a desired result and are chosen solely for their income tax consequences. It should not have been terribly surprising to discover that under current law, each form of transaction is taxed very differently from the others. While regrettable, such inconsistency of treatment is not uncommon under the Code. What should be surprising, however, is that these inconsistent tax burdens are not required by the Code itself, but are attributable to inconsistent analysis of the significance of fresh investment in the three contexts.

There is little basis for the hope that the bewildering complexity of the tax laws will ever be materially diminished through a simplification of the statutory detail. But the complexity, as well as the inappropriate tax burden, produced by simple misapplication of Code provisions can and must be reduced. It would be foolish to suggest that erroneous constructions of the tax laws can be entirely eliminated or that they derive from a single identifiable cause. Courts will err and litigants on both sides will assert extreme positions that at times will prevail. Indeed, the positions criticized herein are in part attributable to a variety of causes ranging from good faith human error to excessive adversarial zeal.

From the broadest perspective, however, the inconsistent analysis of comparable transactions is often attributable to an excessively narrow approach to the fashioning of rules of taxation. If rules are adopted by

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liquidation-reincorporation. Not only does such a use stretch the scope of the section beyond comprehensible limits, but § 351 lacks a dividend equivalence provision. Thus, even if the § 351 attack succeeds, all boot is entitled to capital gains taxation and the resulting corporation thereby obtains an upwards basis adjustment for assets transferred to it. I.R.C. § 362(a). As a result, transactions brought within § 351 will receive substantially different treatment from that imposed upon transactions governed by the F reorganization, although the only difference between the transactions is the amount of fresh investment obtained. As stated repeatedly in the text, fresh investment properly does not have such significance to the taxation of the old stockholders.

the Treasury, or by Congress and the courts, simply with a view to the expedient resolution of immediate problems and with inadequate consideration of the consistency of the rules with other developed doctrines within the taxing system, anomalies such as those addressed herein will be unavoidable. Such myopia in the development of the taxing system could well create a law of unmanageable complexity. It has been demonstrated here that, in at least some contexts, the consistent application of developed principles both is productive of a more rational taxing system and is an entirely practical objective.