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THE TAXATION OF REINVESTED CORPORATE EARNINGS

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I. Introduction

As long as capital gains are favored with reduced tax rates, the exhilaration of converting ordinary income into capital gains will continue to motivate taxpayers. In the case of corporate earnings, the invitation to convert is derived from the Internal Revenue Code¹ (I.R.C. or Code), which permits a shareholder capital gains treatment upon the sale or redemption of stock at a gain.² The Code works its magic even when some or all of the value received for the stock represents payment for corporate earnings that are retained by the corporation and which would have commanded dividend treatment to the shareholder had they been distributed prior to disposition.

The dramatic difference between the tax bite of capital gains and ordinary income has spawned a welter of statutory provisions to discern whether a corporate distribution is, in fact, a dividend or

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1. I.R.C. § 1-9031 (1976 & Supp. IV 1980).

2. Throughout this article, it is assumed that stock is a capital asset in the hands of a shareholder. See I.R.C. §§ 1221 (1981) (definition of capital assets), 302 (exchange treatment for redemption), 1202 (capital gains treatment). See also *id.* §§ 331, 346 (liquidations).

a payment entitled to capital gains treatment.³ For example, I.R.C. section 302(b)(2) sets out a numerical safe harbor to insure capital gains treatment if a corporation redeems a meaningful percentage of a shareholder's stock.⁴ Otherwise, dividend treatment may result.⁵ Sections 304 and 306 were enacted to prevent a bailout of corporate earnings at a capital gains rate through a sale of stock by a shareholder in a transaction that amounted to an unsuccessful redemption under I.R.C. section 302.⁶ Congress enacted the accumulated earnings and personal holding company tax provisions to encourage corporations to make "sufficient" dividend distributions rather than to permit shareholders to enjoy capital gains treatment of "excess" reinvested earnings through redemption, sale, or liquidation.⁷

In spite of these and other statutory nets,⁸ it is still far from clear when distributions from corporations will constitute dividend income and when capital gains treatment will result.⁹ The confusion and uncertainty are all the more unsettling when economically identical transactions result in dissimilar tax consequences, depending on the chosen form. The following model highlights the problem.

X Corporation (X Corp. or X) was formed by unrelated shareholders A and B, each holding sixty shares of common stock (all of X Corp.'s outstanding stock) with a basis of \$100. X Corp. was organized with assets of \$2,400 which annually will produce \$240 of

3. For a taxpayer who is in the 50% bracket, classification as a capital gain reduces the tax burden to 20%. *Id.* § 1202.

4. *Id.* § 302(b)(2).

5. *See id.* § 302(d).

6. Section 304 addresses the "sale" of stock to a corporation affiliated with the issuer. *See generally* Marans, *Section 304: The Shadowy World of Redemptions Through Related Corporations*, 22 TAX L. REV. 161 (1967). Section 306 addresses the preferred stock bailout where the shareholder receives a nontaxable stock dividend of preferred stock, "sells" it at capital gains rates, and then causes or observes the redemption of stock from the "purchaser." *See generally* Lowe, *Bailouts: Their Role in Corporate Planning*, 30 TAX L. REV. 357 (1975).

7. *See* I.R.C. §§ 531-537 (accumulated earnings), 541-547 (personal holding company).

8. *See, e.g., id.* §§ 341 (collapsible corporations), 333(c) (ordinary income recognition in certain liquidations), 318 (attribution rules).

9. Compare the I.R.S. position in *Waterman S.S. Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970), *cert. denied*, 401 U.S. 939 (1971), with its position in *Casner v. Commissioner*, 450 F.2d 379 (5th Cir. 1971).

earnings, capitalized at 10% by *A* and *B*. In addition, *X Corp.* has \$1,200 of cash representing earnings and profits accumulated since its formation. Because *A* and *B* have investment opportunities for the \$1,200 earnings more fruitful than those available to *X*, *X* decides to distribute the \$1,200. At the same time *B*, for personal reasons, needs \$1,200 and is willing to reduce his ownership in *X Corp.* to a 25% interest. The following transactions are considered, each of which results in *X* distributing \$1,200, *B* receiving \$1,200, *A* increasing his ownership interest in *X Corp.* to 75%, and *B* reducing his ownership in *X Corp.* from 50% to 25%.

Case 1 - *X* distributes \$1,200 to *B* and 120 shares of *X* stock worth \$1,200 to *A*.

Case 2 - *X* redeems forty shares from *B* for \$1,200.

Case 3 - *X* distributes \$600 to *A* and \$600 to *B*. *A* buys thirty shares from *B* for \$600.

Case 4 - *B* sells thirty shares to *A* for \$900, and *X* then distributes \$900 to *A* and \$300 to *B*.

Case 5 - *B* sells fifteen shares to *A* for \$450, and *X* then redeems twenty shares from *B* for \$600. *X Corp.* then makes a distribution of \$450 to *A* and \$150 to *B*.

Under existing law, assuming the transactions in each case occur in the same taxable year and are respected, the tax consequences vary dramatically:

Case 1 - *A* and *B* each has \$600 ordinary income on the distribution,¹⁰ reduces his basis to \$0 and records a \$500 capital gain. *A* has a \$1,200 stock basis in the stock received as a dividend.¹¹

10. Throughout this article, the dividend exclusion provided by I.R.C. § 116 is ignored for ease of analysis. Similarly, the impact of corporate taxes on valuation is not considered.

11. The distribution is governed by I.R.C. §§ 301 and 305(b)(2). Although I.R.C. § 301(c)(2) permits an offset in basis before capital gains treatment results, the provision is silent concerning whether the newly acquired basis of the stock dividend under § 301(d) can be applied. If the application were permissible, *A* would have no capital gain, but instead would offset \$600 of his \$1,300 stock basis (\$100 original basis and \$1,200 by virtue of § 301(d)), leaving a \$700 basis. However, I.R.C. § 301(c)(2) refers to the "adjusted basis of the stock" (emphasis added) which, under § 301(a), appears to refer to the stock on which the distribution was made, or, in this case, the original 60 shares. Cf. William H. Kinch, 1942 T.C.M. ¶ 42,613 (P-H) (distribution on common in excess of earnings triggered § 301(c)(3) capital gain after common basis was reduced to \$0, and could not be applied to reduce basis of shareholder's preferred stock). See generally Note, *Aggregation of Bases Under Sections*

Case 2 - *B* has a capital gain of \$1,200 minus the basis of forty shares (\$66.67) or \$1,133.33, and a basis of \$33.33 in the remaining twenty shares. *A* will have no tax consequences.¹²

Case 3 - *A* and *B* each has \$600 ordinary income on the distribution. *B* will have a \$550 capital gain on the sale of one-half of his shares to *A* and a basis in the remaining shares of \$50. *A* will have a total stock basis of \$700.¹³

Case 4 - *B* has an \$850 capital gain on the sale and \$300 ordinary income on the distribution, leaving a basis of \$50 in his remaining shares. *A* will have \$900 of ordinary income on the distribution and a total stock basis of \$1,000.¹⁴

Case 5 - *B* has a \$425 capital gain on the sale, a \$566.67 capital gain on the redemption, and a \$150 dividend. *B*'s basis in his remaining *X* stock is \$41.67. *A* will have a \$450 dividend on the distribution, ending up with a total basis of \$550 in his *X* stock.¹⁵

301(c)(2) and (3), 33 TAX LAWYER 937 (1980).

12. The redemption qualifies under I.R.C. § 302(b)(2) which allows *B* capital gains treatment, including that portion of the gain attributable to his share of the earnings and profits. Although I.R.C. § 305(b)(2) in conjunction with § 305(c) poses a threat to *A* (the nonredeeming shareholder), it is clear that § 305(b) has no application to isolated redemptions. See S. REP. NO. 552, 91st Cong., 1st Sess. 153 (1969); Treas. Reg. § 1.305-3(e), Exs. 10-12, T.D. 7281, 1973-2 C.B. 92, 100-01. The logic behind this distinction has been called into question. See Stone, *Back to Fundamentals: Another Version of the Stock Dividend Saga*, 79 COLUM. L. REV. 898, 929 (1979). Although Professor Stone would not tax nonredeeming shareholders on any redemption, proposed § 300 would tax all nonredeeming shareholders.

13. In Case 3, *B* can only offset one-half of his basis on the sale, whereas in Case 1, I.R.C. § 301(c)(2) allows full offset of his basis on the distribution.

14. This formulation places *B* somewhere in between Case 1 (heavy ordinary income component) and Case 2 (no ordinary income component), because even those sales proceeds attributable to the earnings and profits underlying the stock value are given capital gains treatment. As the recipient of the distribution covered by earnings and profits, *A* will have dividend treatment under I.R.C. § 301 even though the earnings and profits were accumulated prior to his acquisition. This "miracle of income without gain" has been ratified by the Supreme Court in *United States v. Phellis*, 257 U.S. 156, 171-72 (1921). See also Treas. Reg. § 1.61-9(c) T.D. 6500, 25 Fed. Reg. 11,402 (1960); Powell, *Income From Corporate Dividends*, 35 HARV. L. REV. 363 (1922).

15. The redemption qualifies under I.R.C. § 302(b)(2) with the basis of the redeemed stock equal to 20 shares ÷ 45 shares × \$75 basis (\$25 of the original \$100 basis was allocated to the stock sold) = \$33.33. Following the redemption, the earnings and profits of *X* Corp. will be reduced pursuant to I.R.C. § 312(e) and Rev. Rul. 79-376, 1979-2 C.B. 133. Regardless of the portion of the \$600 redemption price charged to the \$1,200 of the earnings and profits, sufficient earnings and profits will exist to cover the \$600 distribution that fol-

The rainbow of tax results in the cases considered above, all of which conclude in an economically identical posture, stems primarily from the Code's inconsistent treatment of earnings and profits. When earnings and profits are distributed with respect to stock, ordinary income treatment results.¹⁶ When earnings and profits are distributed in a meaningful redemption of stock, capital gains result.¹⁷

The inclusion of reinvested corporate earnings in the capital gains computation runs counter to the general economic theory that "the essential element in a capital gain or loss is its unexpected character."¹⁸ To illustrate, consider the purchase by A of a piece of investment property, suitable only for grazing, with a \$100 fair market value. That value represents the market's discounting of the expected returns on the property by the rate of interest and by a rate reflecting the level of perceived risk.¹⁹ Accordingly, if the expected return were \$10 a year in perpetuity and the risk-adjusted discount rate were 10%, a \$100 fair market value results.²⁰ Now, as the property produces the expected rents of \$10 a year,

lowers the redemption.

16. See I.R.C. §§ 301, 316.

17. See *id.* §§ 302, 1222. Similarly, a sale of stock produces capital gains, assuming the seller is not a dealer, even though part of the stock's value may be due to accumulated earnings and profits.

18. L. SELTZER, *THE NATURE AND TAX TREATMENT OF CAPITAL GAINS AND LOSSES* 47 (1951). But see R. GOODE, *THE INDIVIDUAL INCOME TAX* 182 (1976).

19. L. SELTZER, *supra* note 18, at 54. See BRUDNEY & CHIRELSTEIN, *CORPORATE FINANCE* 35-78 (1979); J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 14-43 (1977).

20. The formula for determining the value of a perpetuity is $PV = A/r$, where PV = present value, A = expected yearly earnings, and r = discount rate.

Present value can be derived from the formula:

$$PV = \frac{A}{1+r} + \frac{A}{(1+r)^2} + \dots + r \frac{A}{(1+r)^n} \quad (\text{Equation 1})$$

This formula determines the present value of an annual return of A for n years discounted at r. Multiplying by (1+r), the formula becomes:

$$PV(1+r) = A + \frac{A}{1+r} + \dots + \frac{A}{(1+r)^{n-1}} \quad (\text{Equation 2})$$

Subtracting Equation 1 from Equation 2:

$$PV(1+r) - PV = A - \frac{A}{(1+r)^n}$$

As n approaches infinity, $\frac{A}{(1+r)^n}$ approaches 0. Therefore, as n approaches infinity:

those rents are treated as ordinary income.²¹ Suppose after one year of rents the property is sold for \$200, its fair market value. The increase in value might be due to any number of factors. The expected earnings might now be perceived to be \$20 a year because of decreased availability of competitive grazing land in the market or increased demand for grazing land. There might be a change in the discount rate. A fall in market interest rates increases the value of a future stream of income and, accordingly, the present value of the property.²² Perhaps the market now requires a lower return to compensate an investor for uncertainties and risks of owning grazing property. All of these changes are "unexpected" because if they were foreseeable, the market would have reflected the information in the price of the property when A purchased it. Accordingly, the increase in value is in a sense a windfall, and should be treated as a capital gain.²³

Suppose instead that A purchases stock in a new corporation for \$100, its fair market value based on expected earnings per share of \$10 and a 10% discount rate. If A receives a dividend of the \$10 of corporate earnings allocable to A's stock, the dividend will be ordinary income.²⁴ If instead, no dividend is paid and A sells his stock after one year for \$110, its fair market value, the gain will be a capital gain even though the \$10 appreciation may be due to the expected corporate earnings that actually were earned rather than to any change in future expected earnings or the discount rate. The transmutation of reinvested corporate earnings into capital gains is a central feature of the American tax system, although justification of such a transmutation is not free from doubt.²⁵ A num-

$$PVr = A$$

$$PV = \frac{A}{r}$$

21. See I.R.C. § 61(a)(5); L. SELTZER, *supra* note 18, at 3.

22. If the expected returns remain at \$10 per year and the discount rate drops to 5%, the present value equals \$200. See *supra* note 20.

23. See Chirelstein, *Fruit-Tree and the Ordinary Income Base*, 1 U. OF BRIDGEPORT L. REV. 1, 4 (1980).

24. See I.R.C. § 61(a)(7).

25. See L. SELTZER, *supra* note 18, at 11; Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985, 1011-13 (1956). Even capital gains taxation can be avoided where, upon death, stock receives a stepped-up basis under I.R.C. § 1014 to a fair market value that reflects reinvested earnings. See, R. GOODE, *THE INDIVIDUAL INCOME TAX* 190

ber of commentators have concluded that special treatment for any capital gains is unwarranted. If so, elimination of reinvested corporate earnings from the capital gains base represents a step in the right direction.²⁶

Although some concern exists that increased taxation of capital gains will increase the "lock in" effect, the conclusion remains substantially unproven and may be overstated.²⁷ Indeed, ordinary income treatment of reinvested corporate earnings recognized on a sale or redemption might result in conflicting tendencies. On one hand, the prospect of an ordinary income component may cause some investors to hold on to their investments until death, at which time I.R.C. section 1014 provides a step-up in basis.²⁸ On the other hand, investors no longer will have the same incentive to postpone transactions to convert ordinary income into capital gains, because earnings and profits under all circumstances will be taxed as ordinary income. In fact, to the extent that an investor chooses to or must sell his stock during his lifetime, ordinary in-

(1976).

26. For example, commentators have noted that full taxation of capital gains is likely to increase progressivity of the tax system. R. GOODE, *supra* note 25, at 192-93; J. PECHMAN, *COMPREHENSIVE INCOME TAXATION* 144 (1977). Moreover, there is likely to be little effect on total savings. J. PECHMAN, *supra* at 142-43. With the increased revenue that would be produced by full taxation, the tax rates might be lowered. G. BREAK & J. PECHMAN, *FEDERAL TAX REFORM* 52 (1975); J. PECHMAN, *supra* at 151.

27. The "lock-in" effect is the reluctance of investors to change their portfolios because to do so causes an avoidable tax liability. An investment switch will be advantageous if $r_s [M - tc(M-C)] > r_o M$, where M is the current market value of the old asset, C is its cost or other basis, tc is the marginal rate of tax on realized capital gains, and r_o and r_s respectively are the ratios of the expected return to current value of the old asset and the new asset. R. GOODE, *supra* note 25, at 197-200. See Beazer, *Expected Income Changes and the Lock-In Effect of the Capital Gains Tax*, 19 NAT'L TAX J. 308 (1966) (refining Goode's formula). Although Goode concludes that locking-in would be increased if tax rates on capital gains were increased without changing the realization rules, others have reached different conclusions. Cf. Beazer, *supra* at 318; Holt & Shelton, *The Lock-In Effect of the Capital Gains Tax*, 15 NAT. TAX J. 337, 351 (1962); Sprinkel & West, *Effects of Capital Gains Taxes on Investment Decisions*, 35 J. BUS. 122, 132 (1962). Compare R. GOODE, *supra* note 25, at 204 and Somers, *Capital Gains Tax: Significance of Changes in Holding Period and Long Term Rate*, 16 VAND. L. REV. 509, 532 (1963) with R. GOODE, *supra* note 25, at 205.

28. Note, however, that I.R.C. § 1014 does not affect a corporation's earnings and profits account. Therefore, the heirs of the stockholder would still have an ordinary income component if their stock were sold at a gain. Although beyond the scope of this article, the incentive to lock-in stock investments might be eliminated by amending the Code to provide for recognition of a ratable share of accumulated earnings and profits on the death of an investor.

come treatment of reinvested earnings provides an incentive for early disposition to prevent bunching of income even though the income averaging provision of I.R.C. section 1301 may offer some relief. Moreover, for the same reason, investors have an incentive to compel corporations to make current distributions of earnings and profits rather than to retain them.²⁹ By taxing reinvested earnings at ordinary income rates regardless of when and how a disposition of stock takes place, the treatment of stock would be brought more into line with the treatment of other capital assets in which conversion of ordinary earnings into capital gains is less likely to occur.

The concept of applying the corporate distribution pattern of I.R.C. section 301 to sales and redemptions has been considered before, but has drawn fire from those who recoil at a new layer of complexity in the tax laws.³⁰ Nevertheless, the present system has engendered complexities and inequities of its own. For example, I.R.C. section 302 labors mightily to determine when a redemption is "essentially equivalent to a dividend" or deserves capital gains treatment, focusing primarily on the percentage of equity surrendered. Other Code sections seek to shore up other weaknesses in

29. Similar conflicting motivations for investors are considered in connection with increasing the holding period for capital gains treatment. Somers, *supra* note 27, at 533. The effects of inflation and rising tax rates on the decision to hold or sell securities is considered in Beazer, *supra* note 27.

To the extent that corporations can be induced to make current income distributions so that investors, without having to consider the capital gains-ordinary income differential, can determine whether to reinvest or make competing investments, misallocations might be eliminated. See BREALEY, *SECURITY PRICES IN A COMPETITIVE MARKET* 20-21 (1971); R. GOODE, *supra* note 25, at 197 ("Many economists argue that capital will be most efficiently allocated if profits are distributed and individual shareholders are allowed to decide whether they should be reinvested where earned or placed elsewhere"); J. PECHMAN, *supra* note 26, at 151; R. POSNER, *ECONOMIC ANALYSIS OF LAW* 237 (1972).

30. See, e.g., Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L. J. 90, 107-17, 149-51 (1977). Professor Clark, in describing one of the "seven basic decisions" of contemporary corporate tax law, notes that "shareholder dispositions of stock are presumptively to be treated purely as dispositions of capital assets, that is, independently of corporate-level events." *Id.* at 107. Citing the complexities of allocating earnings and profits to individual shares, Professor Clark concludes that efficient capital markets and administrative reality demand this "corporate veil" principle. *Id.* at 151.

For another approach to the reinvested earnings problem, see O'Kelley, *Corporate Distributions and the Income Tax: A Consideration of the Inconsistency Between Subchapter C and Its Underlying Policy*, 34 VAND. L. REV. 1 (1981).

the redemption structure.³¹ The economic resources and the contorted legal reasoning involved in determining whether various "bailout" transactions transform ordinary income to capital gains also have been significant.³² Whether elimination of the corporate veil principle would create more complexity than it would clear up is conjectural. This Article will propose a statutory framework that theoretically will clear away some of the existing complexity and incongruity.

Briefly, the purpose of this proposed framework is to offer a tax-neutral system to shareholders who receive payments in connection with their stock whether those payments originate from transactions normally considered dividends, redemptions, or sales. To function, the system must force shareholders to recognize ordinary income on any payment in connection with their stock to the extent of a ratable share of earnings and profits. Before discussing the proposed framework in detail and examining its application to the hypothetical cases discussed above, it is necessary to state the assumptions underlying the framework and to indicate the scope of the Article.

A basic assumption underlying the proposal is that to the extent possible, identical economic results should dictate identical tax results. Aside from its logical ring, this principle has been embraced by Congress in a variety of circumstances. For example, I.R.C. section 337, the anti-*Commissioner v. Court Holding Co.*³³ provision, was enacted to produce similar tax results in a liquidation setting whether a sale of assets was made by the liquidating corporation or its shareholders. I.R.C. section 334(b)(2) was enacted to equalize the tax treatment when a corporation directly purchases assets of another corporation and when it purchases stock for purposes of liquidating the corporation.

The framework proposed in this Article does not purport to eliminate the difference in treatment between capital gains and ordinary income in most respects. Thus, when the increase in the value of an asset is due to perceived increased earnings potential or

31. See, *supra* note 6.

32. See Clark, *supra* note 30, at 113-16. See also B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶¶ 7.07, 9.25 (4th ed. 1979) [hereinafter cited as BITTKER & EUSTICE].

33. 324 U.S. 331 (1944).

a change in the discount rate, capital gains treatment is assumed appropriate. When the increase is due to reinvested earnings, however, ordinary income treatment is proposed. The proposal does not address other issues related to capital gains taxation such as the full integration of corporate and individual income tax liabilities.³⁴

Several other bulwarks of the tax system are not scrutinized.³⁵ The step-up in basis provided in I.R.C. section 1014, which also enhances the appeal of reinvested earnings, is unchallenged. The concept of realization central to the American tax system would remain largely intact; an individual investor would not be taxed when a corporation initially earns income.³⁶ In keeping with *Eisner v. Macomber*,³⁷ no tax would lie when a corporation makes a pro rata distribution of its own stock.³⁸ An investor may not offset any nonstock distributions with the decrease in the value of his existing stock, nor may he realize such a decrease on corporate distributions to other shareholders. Under the proposed framework, however, any change in the value of an investor's stock resulting from a redemption of the shares of other investors is realized.³⁹ The differences in treatment between debt and equity are accepted.⁴⁰ Accordingly, debt ownership is ignored in calculating pro-

34. See generally G. BREAK & J. PECHMAN, *supra* note 26, at 44-52; J. PECHMAN, *supra* note 26, at 116-62.

35. See generally Clark, *supra* note 30.

36. This is in keeping with the dual system of taxation whereby corporations and shareholders are separately taxed. For suggested reforms in this area, see Warren, *Integration of Individual and Corporate Income Taxes*, FEDERAL INCOME TAX SIMPLIFICATION 313 (Gustafson ed. 1979).

37. 252 U.S. 189 (1920).

38. *Id.* at 208-19.

39. Under existing law, I.R.C. § 305(c) and § 305(b)(2) provide for constructive realization where a shareholder's proportionate ownership interest increases. Section 305(c), however, applies only to redemptions that under § 302(d) are treated under § 301, and the regulations further narrow the constructive realization concept to redemptions under § 301 that are not isolated. Treas. Reg. § 1.305-3(e), Exs. 10, 11, T.D. 7281, 1973-2 C.B. 92. The proposed framework expands this realization concept to all redemptions.

40. Paradoxically, a stock distribution to a sole shareholder is not taxable under *Eisner v. Macomber*, *supra* note 37, while a distribution of a corporate note to a sole shareholder is taxable under *Bazley v. Commissioner*, 331 U.S. 737 (1947). In each case, the shareholder merely has recharacterized his interest in the corporation. See I.R.C. § 385 and the proposed regulations thereunder. See generally Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis And A Proposal*, 26 TAX L. REV. 369 (1971).

portionate changes in a shareholder's participation in a corporation.

Other unchallenged concepts include the use of earnings and profits as a measure of dividend income,⁴¹ the maintenance of the *General Utilities & Operating Co. v. Helvering*⁴² principle that distributions in kind generally do not produce tax consequences at the corporate level,⁴³ and the exclusions and deductions allowed by I.R.C. sections 116 and 243 to 245.

For the most part, the Article will focus on operating distributions by a corporation with only summary consideration of the liquidation and reorganization provisions. Also, the analysis focuses on individual shareholders, recognizing that existing provisions designed to deal with corporate shareholders might be adapted with little problem.⁴⁴

With these assumptions in mind, the Article turns to the proposed statutory framework for corporate distributions, referred to as proposed section 300.⁴⁵ Proposed section 300 consolidates existing I.R.C. sections 301, 302, 305, and 306, while impacting on several other Code provisions including those addressing liquidation, collapsible corporations, and the treatment of boot in reorganization.

II. THE OPERATION OF PROPOSED SECTION 300

The heart of proposed section 300 lies in the recognition of an ordinary income component as measured by earnings and profits on sales and redemptions. To quantify that component and to ensure that identical economic consequences generate identical tax consequences, proposed section 300 recharacterizes stock transfers in the following manner. First, proposed section 300 treats a corpo-

41. For a reexamination of the earnings and profits principle, see Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal*, 53 TAXES 68 (1975). The analysis under proposed § 300 assumes the "nimble dividend" concept of I.R.C. § 316(a)(2) is removed. The outdated origin of the concept is explained in *Bittker & Eustice*, *supra* note 32, at ¶ 7.02.

42. 296 U.S. 200 (1935).

43. Clark, *supra* note 30, at 130-35.

44. See, e.g., I.R.C. §§ 301(b)(1)(B), (d)(2).

45. Proposed § 300 does not in its present form aspire to statutory precision, but is intended solely as a framework. See Appendix.

rate payment in redemption as a pro rata distribution to both redeeming and appropriate nonredeeming shareholders who must account for the distributions as they would any corporate distribution unconnected to a redemption. Then, the nonredeeming shareholders make contributions to capital in the amount of their deemed distributions which simultaneously are distributed to the redeeming shareholders in exchange for their shares. There will be further gain or loss recognized to the redeeming shareholders on this aspect of the analysis. The reason for these contortions is to take into account the benefit that accrues to certain nonredeeming shareholders from a redemption. Dividend treatment can result to the extent that a nonredeeming shareholder has increased his equity interest in the corporation relative to other shareholders.⁴⁶

Second, proposed section 300 recharacterizes stock transfers by treating a sale or exchange by a shareholder as the simultaneous closing of a corporate account by the seller and opening of an account by the purchaser. In closing the account, the seller must account for his share of earnings and profits. Accordingly, a sale or exchange is treated as a simultaneous redemption of the seller's shares and purchase of those shares from the corporation. On the deemed redemption, the seller will account for his share of earnings and profits as ordinary income.

Another integral part of proposed section 300 is its emphasis on quantity of stock ownership rather than quality. The market value of stock determines the tax effects on a redemption or stock distribution, regardless of any preferences or voting rights. In this manner, proposed section 300 rejects qualitative judgments like those in I.R.C. sections 305, 302(b)(2), and 306 in favor of the fair market value concept illustrated in section 542(a)(2). Proposed section 300 takes the position that the fair market value of stock will reflect market assessment of its qualitative features.

46. Professor Blum has defined a dividend as "an occurrence that entails a transfer, direct or indirect, of something of value from the corporation to a shareholder without substantially reducing the equity interest of that shareholder vis-a-vis other owners of the equity." Blum, *Drawing the Line Between Dividends and Investment Adjustments: A Proposal for More Consistency*, 55 TAXES 30, 31 (1977). A nonredeeming shareholder can dispose of a portion of his equity without lessening his equity interest in the corporation. For example, if A and B each owns 60 shares of X Corp. stock, and X Corp. redeems 40 shares from B, A can sell 20 shares without lowering his 50% equity interest in the corporation.

A. *Proposed Section 300*

PROPOSED SECTION 300(1).

The term "distribution" means a payment of property with respect to or in redemption of the corporation's stock.

Under the proposal, all corporate payments in connection with stock will be treated similarly.

PROPOSED SECTION 300(2).

The term "property" includes money, securities, and stock in the corporation making the distribution, or rights to acquire such stock.

This definition differs from existing I.R.C. section 317(a) by including a distributing corporation's own stock and stock rights as property subject to the distribution rules. Under present law, stock, although not directly considered "property" for purposes of I.R.C. section 301, achieves constructive property status by virtue of section 305(b).

PROPOSED SECTION 300(3).

The term "redemption" means the acquisition by a corporation of its stock from a shareholder in exchange for property, whether the stock so acquired is cancelled, retired, or held as treasury stock.

This merely is a restatement of existing I.R.C. section 317(b).

PROPOSED SECTION 300(4).

Any actual distribution with respect to a class of stock is deemed to be pro rata to the shareholders holding such stock. Any actual distribution in redemption of a class of stock is deemed to be pro rata to the shareholders holding such stock or a less preferred class of stock to the extent that the value of such shareholders' stock increases as a result of the surrender of shares. Distributions of the distributing corporation's own stock shall have no tax consequences unless the distribution increases the proportionate interests of the receiving shareholders in the assets or earnings and profits of the corporation.

The pro rata distribution rule as applied to nonredemption distributions should not cause problems, because shareholders of any class of stock presumably will receive pro rata distributions. Under the proposal, however, not only the amounts but the quality of the

distributions will be deemed to be pro rata, with any actual differences in the quality of the property received accomplished through deemed inter-shareholder transfers.⁴⁷

The rule as applied to redemptions is the first step in recognizing that economically a redemption is indistinguishable from a pro rata distribution followed by a sale from the "redeemed" to the remaining shareholders⁴⁸ or a stock dividend to the remaining shareholders and a cash dividend to the "redeemed."⁴⁹

The third sentence of proposed section 300(4) focuses on some of the problems currently addressed in I.R.C. section 305. The proposal differs from current law in recognizing that the only stock dividends that should be taxable are those that give the receiving shareholder a disproportionate increase in the distributing corporation relative to the nonreceiving shareholders. This proportionality test differs from the test developed by the Supreme Court and Congress in that the quality of the stock received, preferred or common, is irrelevant in determining tax consequences. Instead, market value and its effect on existing stock value alone will determine taxability.⁵⁰

PROPOSED SECTION 300(5).

Any transfer of stock by sale or exchange shall be treated as a

47. For example, if A and B are the only shareholders of X Corp., and A receives a \$1,200 distribution and B receives a stock distribution of 120 shares of X Corp. worth \$1,200, proposed § 300 would treat each as receiving \$600 and 60 shares of X stock followed by a sale from A to B of 60 shares for \$600.

48. See Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 749 (1969).

49. In a situation in which there are multiple classes of stock outstanding (e.g., preferred and common), the redemption of shares from the preferred class is likely to increase (or at least not decrease) the value of the common shares outstanding. Therefore, a pro rata distribution should be deemed made to the common shareholders who then contribute the deemed distribution to capital to redeem the preferred shares. See Donaldson, *In Defense of Preferred Stock*, 40 HARV. BUS. REV. 123, 129-30 (1962). For a discussion of preferred stock redemptions see *infra* pp. 23-25.

50. For a discussion of the development of the proportionate interest test, see Del Cotto & Wolf, *The Proportionate Interest Test of Section 305 and the Supreme Court*, 27 TAX L. REV. 49 (1971). The authors note that the Supreme Court, in *Helvering v. Gowran*, 302 U.S. 238 (1937) (preferred on common with preferred outstanding) and *Koshland v. Helvering*, 298 U.S. 441 (1936) (common on preferred with common outstanding), found taxability where a different kind of stock interest was distributed. However, in *Helvering v. Sprouse*, 318 U.S. 604 (1943) (pro rata distribution of nonvoting common on both voting and nonvoting common) and *Strassburger v. Commissioner*, 318 U.S. 604, 607 (1943) (pro rata distribu-

redemption and a simultaneous purchase from the corporation. Any transfer of stock by redemption shall be treated as a redemption and a simultaneous contribution to capital of the corporation by the remaining shareholders both in the amount of the deemed distribution.

While proposed section 300(4) prescribes the treatment of shareholders with respect to corporate distributions, proposed section 300(5) focuses on the treatment of shareholders when they transfer their stock either in connection with or apart from a corporate distribution. To assure equal tax treatment whether the transfer is in the form of a sale or a redemption, all transfers are treated as redemptions simultaneously linked to a purchase from the corporation in the case of a sale, or a contribution to capital in the case of a redemption. In the case of a redemption, the contribution will be equal to the deemed distribution resulting from proposed section 300(4). By recasting all transfers as redemptions, proposed section 300(5) assures uniform treatment and, in conjunction with proposed section 300(6), guarantees that any receipt from the transfer of stock will carry with it ordinary income treatment to the extent of the ratable share of earnings and profits, because in either a sale or redemption, a portion of a stock's fair market value may be due to the corporation's retained earnings and profits.

PROPOSED SECTION 300(6).

On any distribution, a shareholder shall treat as ordinary income any proceeds to the extent of his ratable share of earnings and profits. On any transfer by sale, exchange, or redemption, a shareholder shall treat as ordinary income any proceeds to the extent of his ratable share of earnings and profits attributable to the stock transferred.

Proposed section 300(6) causes shareholders to recognize as ordinary income a ratable share of earnings and profits, regardless of the form of the transaction, whenever a shareholder receives or is deemed to receive property that reflects a corporation's earnings

tion of preferred on common), the Court emphasized the need for a change in proportionality as well. While I.R.C. § 305(b)(2) attempts to adopt the notion of proportionate change as a prerequisite for taxability of certain stock dividends, I.R.C. §§ 305(b)(3) and (4) focus solely on the nature of the stock interest distributed and on which the distribution is made.

and profits.⁵¹ A shareholder's ratable share of earnings and profits for purposes of measuring ordinary income on a distribution is determined in proposed section 300(9). When a stock transfer is involved, proposed section 300(10) limits a shareholder's ratable share of earnings and profits to the portion attributable to the stock transferred.⁵²

The interplay of proposed sections 300(4), (5), (6), (9), and (10) is illustrated best by a redemption. The initial payment by a corporation in redemption is characterized as a pro rata distribution by section 300(4). Each shareholder must report ordinary income on the distribution in accordance with the first sentence of section 300(6) to the extent of his ratable share of earnings and profits as determined by section 300(9). Having analyzed the distribution aspect of the transaction, proposed section 300 focuses on the redemption aspect. The second sentence of section 300(5) characterizes the redemption, while the second sentence of section 300(6) along with section 300(10) outline the ordinary income component of the redemption aspect.

PROPOSED SECTION 300(7).

Any amounts distributed in excess of a shareholder's ratable share of earnings and profits shall first be applied against a shareholder's basis in his stock (but not in excess of basis allocable to any stock transferred), and then be treated as gain from the sale or exchange of property.

Proposed section 300(7), in conjunction with proposed section 300(6), puts into place the taxing regime of existing I.R.C. section 301(c) under which distributions are applied first against earnings

51. Proposed § 300(4), which taxes distributions based on a ratable share of earnings and profits, is like I.R.C. §§ 356(a)(2), 333, and 306 under existing law. I.R.C. § 316 does not on its face limit taxability to a ratable share if a distribution is "out of" earnings and profits.

52. Proposed § 300(6) requires a shareholder to recognize the ordinary income component on a transfer even if the transfer is at a loss. To illustrate: A, sole and original owner of X Corp., holds stock with a \$2,000 basis and a \$1,500 fair market value. X Corp. has assets consisting of \$500 of earnings and profits, and \$1,000 in working capital. If A sells his stock for \$1,500, proposed § 300(6) will require the recognition of \$500 in ordinary income. The \$1,000 unreturned basis under proposed § 300(7) can be deducted as a \$1,000 capital loss. Regardless of what has happened to A's original capital, he has received \$500 on the sale representing X's earnings, and he should be taxed on that amount. Capital loss treatment is appropriate because the original \$2,000 capital contribution has diminished in value to \$1,000.

and profits, next against basis, and finally treated as capital gains. These layers apply to actual distributions and deemed distributions under the pro rata rule of proposed section 300(4) and the transfer rule of proposed section 300(5).

PROPOSED SECTION 300(8).

In determining gain on a transfer, the basis of stock transferred equals the product of a shareholder's basis in the class of stock transferred and the percentage decrease in the shareholder's stock ownership of that class as a result of the transfer.

This provision does not affect existing law with respect to allocation of basis on any sales transaction.⁵³ If a shareholder sells one-half of his stock, one-half of his basis is allocable to the stock sold. Proposed section 300(8) recognizes, however, that a sale of *X* common shares has far different consequences than a redemption of *X* common shares in terms of the shareholder's continuing investment in the corporation, and that basis allocation should reflect this difference. For example, if *A* owns sixty of the 120 common shares outstanding and sells thirty shares, one-half of his basis in the sixty shares should offset the sales proceeds because *A*'s investment in the common stock has been halved from 50% to 25% (thirty out of 120 shares outstanding). If, however, *X* redeems thirty shares from *A*, his interest in the common stock declines from 50% to 33.33% (thirty out of ninety shares outstanding). Regardless of the number of shares actually surrendered, *A*'s percentage of ownership has declined only 33.33%.⁵⁴ Accordingly, the basis recovery should be limited to 33.33% of *A*'s original basis in the sixty shares. Proposed section 300(8) simply recognizes that *A*, by redeeming thirty shares, is in no different an ownership position

53. Proposed § 300(8) is not intended to prevent a shareholder from selling or redeeming a specific block of stock with a specific basis as is permitted under existing law. *See, e.g., Lakeside Irrigation Co. v. Commissioner*, 128 F.2d 418 (5th Cir. 1942), *cert. denied*, 317 U.S. 666 (1942). In such a case, the specific block of stock should be treated as a class of stock for purposes of proposed § 300(8).

54. The measure of changes in ownership for purposes of proposed § 300 is the fair market value of stock held. When only one class of stock is outstanding, the percentage decrease in the stock ownership serves as the same measure. Thus, *A*'s decrease in stock ownership can be expressed by the following ratio:

16.67% decline in percentage ownership
50% original ownership

than had he sold twenty shares leaving him with 33.33% of the outstanding shares (forty out of 120). Because only one-third of A's total basis would be allocable to a sale of twenty shares, the same result should follow on a redemption of thirty shares.

PROPOSED SECTION 300(9).

*A shareholder's ratable share of earnings and profits equals the sum for all years of the product of the current earnings and profits allocable to any class of stock on which a distribution is made and the shareholder's percentage of stock ownership of such class on January 1 of the year.*⁵⁵

The determination of ratable earnings and profits is complicated by at least two factors. First, the allocation of earnings and profits to different classes of stock is speculative, although the Code in its present form requires such an allocation upon a sale or exchange of stock in certain foreign corporations pursuant to I.R.C. section 1248(a).⁵⁶ Second, newly acquired stock ownership by actual purchase or constructive acquisition through redemption of other shareholder's holdings cannot be counted in determining a shareholder's ratable share of previously earned earnings and profits. This follows logically from the fact that the newly acquired stock's share of previously earned earnings and profits was taken into account upon either the redemption or sale in accordance with proposed section 300(6). Proposed section 300(9) meets this problem by focusing on earnings and profits accumulated after stock is acquired.

One of the benefits of proposed section 300(9) is the elimination of the miracle of income without gain when a purchaser of stock, who receives a distribution from accumulated earnings and profits the day after the purchase, has dividend income.⁵⁷ Proposed sections 300(4) to (6) require immediate recognition of ordinary gain

55. Because earnings and profits are determined at the end of a year to evaluate the quality of distributions made during that year, see I.R.C. § 316(a)(2), the transferor of stock must account for current earnings and profits accumulated after, but in the same year as, the transfer. The transferee, or constructive transferee in the case of a nonredeeming shareholder, must account for earnings and profits in the year after acquisition.

56. See Treas. Reg. §§ 1.1248-2, -3, T.D. 6779, 1965-1 C.B. 383, amended by T.D. 7293, 1973-2 C.B. 228 and Treas. Reg. §§ 1.951-1(e)(2), (3) (1965).

57. See Rev. Rul. 56-211, 1956-1 C.B. 155 (illustrating income without gain). See also *supra* note 14.

to the extent of earnings and profits on any sale so that any subsequent distribution to the purchaser in the absence of newly earned earnings and profits will represent a return of basis pursuant to proposed section 300(7).

PROPOSED SECTION 300(10).

The term "ratable share of earnings and profits attributable to the stock transferred" means the product of the shareholder's ratable share of earnings and profits and the percentage decrease in the shareholder's stock ownership in the class of stock transferred as a result of the transfer.

Proposed section 300(10) defines a term used in the second sentence of proposed section 300(6). The purpose of the term is to limit the ordinary income potential in a transfer situation to earnings and profits attributable to the stock transferred rather than a shareholder's total share of earnings and profits. Proposed section 300(10) is not intended to prevent a shareholder from selling or redeeming a specific block of stock which may not be as ripe with earnings and profits as other blocks. If the shareholder can prove the actual earnings and profits allocable to the block transferred, he should not be bound by the formula in proposed section 300(10).⁵⁸

B. Application of Proposed Section 300: Common Stock

With proposed section 300 set out, the problem offered above⁵⁹ yields identical tax treatment regardless of the method used to reach the end result. To briefly restate the example: X Corp., with original shareholders A and B each holding sixty shares of common stock with a basis of \$100, was formed with \$2,400 in assets and has earned \$1,200 which is available for distribution. A variety of transactions are considered by which A increases his ownership interest to 75%, X Corp. distributes \$1,200, and B receives \$1,200 while decreasing his ownership percentage to 25%.

Case 1—X distributes \$1,200 to B and 120 shares of X stock, worth \$1,200, to A.

58. See, e.g., *Lakeside Irrigation Co. v. Commissioner*, *supra* note 53; Rev. Rul. 76-377, 1976-2 C.B. 89.

59. See discussion *supra* p. 3.

Under both existing law and the proposal, *A* and *B* each has \$600 of ordinary income. The difference in approach between existing law and proposed section 300 with respect to *B* lies in the capital gains component. I.R.C. section 301(c)(2) permits *B* to offset his entire basis upon receiving \$600 in excess of his share of earnings and profits; therefore, under I.R.C. section 301(c)(3), *B* receives a \$500 capital gain. Under proposed section 300, *B* ends up with a \$550 capital gain and a \$50 basis. As to *A*, proposed section 300 removes the \$500 capital gain that would be recognized under I.R.C. section 301, while leaving *A* with a \$700 basis.

Proposed section 300(4) deems that *A* and *B* each receives a distribution of \$600 and sixty shares. As equal shareholders, they should be entitled not only to the same amount but the same quality of distribution. The pro rata distribution of sixty shares to *A* and *B* fosters no tax consequences pursuant to the last sentence of proposed section 300(4). In accordance with existing I.R.C. section 307, *A* and *B* each allocates \$50 of basis to the new shares. Proposed sections 300(6) and (9) require *A* and *B* each to report \$600, his ratable share of earnings and profits, on the distribution of cash as ordinary income. To get from the hypothetical distribution to the actual result, *A* is deemed to purchase *B*'s sixty shares for \$600 which, pursuant to proposed sections 300(5) and (7), results in a \$550 capital gain to *B* who retains a \$50 basis in his remaining sixty shares. *A* has a total basis in his 180 shares of \$700 (\$100 original basis plus \$600 cost basis). The effect of the proposal in Case 1 is to conform the events to those in Case 3.

Case 2—*X* redeems forty shares from *B* for \$1,200.

Although existing I.R.C. section 302(b)(2) gives *B* a capital gain of \$1,133.33 (\$1,200—\$66.67 basis), proposed section 300 gives a tax result identical to that in Case 1. Under the proposal, not only is *B* taxed on ordinary income to the extent of his ratable share of earnings and profits, but *A* is taxed to the extent that the fair market value of his stock increased due to *B*'s surrender of stock.⁶⁰

60. One would expect a straight distribution of \$1,200 to decrease the fair market value of *A*'s stock from \$30 per share to \$20 per share. Because *B* surrenders 40 shares in exchange for the \$1,200, *A*'s stock continues to be valued at \$30 per share. *A* has realized a \$10 per share benefit, or \$600, resulting from *B*'s surrender of shares.

Although A does not actually receive a distribution, his position after the redemption is the same as if he had received a cash distribution and purchased one-half of B's 50% interest.⁶¹ To provide tax liability for A in Case 2, as in Case 1, is to create a cash obligation without any income. A is in a position after B's redemption, however, to sell twenty shares for their \$600 fair market value at no gain without diluting his original participation in the corporation. After the sale, A would own forty out of eighty shares outstanding.⁶² The opportunity to sell in a public corporation presents no problem. In a closely held corporation, potential shareholders presumably would become more responsive to those investment opportunities that met the needs of nonredeeming shareholders for cash to pay taxes. The notion of tax liability without cash is not foreign to the Code in its present form. For example, a stock dividend falling within I.R.C. section 305(b)(2), or any other part of section 305(b), causes the same problems and is no different in economic result than a redemption.⁶³

Proposed section 300 is applied to Case 2 by analyzing first the distribution and then the surrender of shares. First, proposed section 300(4) renders the \$1,200 distribution pro rata, \$600 to each A and B. Second, proposed sections 300(6) and (9) tax A and B each on \$600 ordinary income. Third, proposed section 300(5) focuses on the redemption element by deeming A to have contributed his \$600 to the capital of X Corp., thereby increasing his basis in X Corp. stock from \$100 to \$700.⁶⁴ X Corp. is then deemed to have redeemed B's forty shares for the same \$600. Fourth, although under existing law the basis of the forty shares redeemed would be

61. See *infra* Case 3. See also Chirelstein, *supra* note 48.

62. Under proposed § 300(5), A, who has \$600 of ordinary income on B's redemption, increases his basis by \$600 on the deemed contribution to capital. That increase is allocable to the portion of A's 75% stock interest representing increased equity participation. One-third of A's 75% interest arose as a result of B's redemption which increased A's participation by 25%. Accordingly, the \$600 basis increase should be allocated to one-third of A's 60 shares, or 20 shares, while A's original 50% interest, or 40 shares, maintain their \$100 basis. When A sells his increased ownership for \$600, there is no gain.

63. Compare Case 1 with Case 2. The solution in Case 1 is similar to that in Case 2. A can sell 60 shares for \$600 at no gain while maintaining a 50% interest in X.

64. See I.R.C. § 118 and Treas. Reg. § 1.118-1 (1960), stating that such payments are "in the nature of assessments upon, and represent an additional price paid for" the stock of the corporation.

\$66.67 ($40/60 \times \100), proposed section 300(8) requires a different basis allocation because *B*'s redemption only reduces his ownership percentage from 50% to 25%, or a 50% reduction. Immediately following the deemed distribution and prior to the redemption, *B*'s stock has a \$1,200 fair market value. After the redemption, *B* holds twenty shares with a \$600 fair market value. Accordingly, instead of allocating two-thirds of his \$100 basis to the redemption, the correct allocation is 50% of \$100, or \$50. After the redemption, *B* continues to hold one-half of his original 50% investment in *X* Corp. with one-half of his \$100 investment yet to be recovered. The gain to *B* on the redemption is \$600 minus \$50, or \$550 which, pursuant to proposed section 300(7), is treated as a capital gain. *X* Corp.'s earnings and profits have been fully accounted for on the deemed pro rata distribution under proposed section 300(4).

Case 3—*X* distributes \$600 to *A* and \$600 to *B*. *A* buys thirty shares from *B* for \$600.

Proposed section 300 effectively treats Cases 1 and 2 as though they were Case 3 with adjustments made for the number of shares outstanding. Although Case 1 results in 240 shares outstanding, Case 2 with eighty shares outstanding, and Case 3 with 120 shares outstanding, all three cases reach the same economic result. Proposed section 300 and existing law solve Case 3 identically. The pro rata distribution is in keeping with proposed section 300(4). *A* and *B* each have \$600 ordinary income in accordance with proposed sections 300(6) and (9). On the sale, proposed sections 300(5), (7), and (8) produce a \$550 gain for *B*, with *A* acquiring a total basis in his *X* stock of \$700 (\$100 original and \$600 cost under I.R.C. section 1012), while *B* retains a \$50 basis in his remaining thirty shares.

Case 4—*B* sells thirty shares to *A* for \$900, and *X* then distributes \$900 to *A* and \$300 to *B*.

Case 4 is similar to Case 3 except that the sale precedes the corporate distribution. Under existing law, the effect of the reversed order of events gives *B* a higher percentage of capital gain on his total income of \$1,150 while *A* receives \$300 of income without

gain.⁶⁵ Proposed section 300 conforms Case 4 to the other cases.

Proposed section 300(5) treats the sale as a redemption by X followed by a purchase from X by A.⁶⁶ The second sentence of section 300(6) gives B ordinary income treatment "to the extent of his ratable share of earnings and profits attributable to the stock transferred." Under proposed section 300(9), B's ratable share of earnings and profits is \$600, and proposed section 300(10) allocates \$300 of that sum to the sale proceeds, producing a \$300 ordinary income component.⁶⁷ Of the remaining \$600 deemed distributed, proposed sections 300(7) and (8) mandate a \$50 recovery of the basis allocable to thirty shares sold, and a \$550 capital gain for the excess received over the basis. A's basis following the purchase is \$1,000 (the \$100 original basis and the \$900 cost basis).

The \$1,200 distribution from X is pro rata according to the stock interests of A and B following the sale, thus satisfying proposed section 300(4). To determine the ordinary income component to A and B pursuant to proposed section 300(6), the ratable share of earnings and profits for A and B must be determined. The \$1,200 earnings and profits account of X is decreased by the \$300 of ordinary income recognized by B on the sale to A. Of the remaining \$900 earnings and profits, B's ratable share under proposed section 300(9) is \$300, and A's is \$600. Proposed section 300(6) then will tax A on \$600 ordinary income, and proposed section 300(7) will result in a basis reduction from \$1,000 to \$700. B will be taxed on \$300 ordinary income under proposed section 300(6).

In sum, B is taxed on \$600 ordinary income (\$300 on the sale and \$300 on the distribution), and \$550 capital gains on the sale, leaving B with a basis of \$50 in his remaining thirty shares. A is taxed on \$600 ordinary income on the distribution and, after the

65. In Case 3, under existing law, B recognizes \$600 ordinary income and \$550 capital gain, whereas in Case 4 the capital gain is \$850 and the ordinary income component is \$300. A, who could expect \$600 ordinary income by virtue of his share of earnings and profits, must report \$900 of ordinary income as a result of his acquisition of 30 shares from B, even though the extra \$300 was earned prior to his acquisition. See *supra* notes 14 & 57.

66. Because proposed § 300(5) provides a *constructive* redemption, proposed § 300(4), which applies to *actual* distributions, does not mandate pro rata treatment.

67. Under the formula of proposed § 300(10), B, who owned stock worth \$1,800 prior to the sale, held only \$900 of stock following the sale, or a 50% decrease. The product of the 50% decrease and B's \$600 ratable share of earnings and profits provides \$300 of earnings and profits attributable to such proceeds.

basis reduction mandated by proposed section 300(7), has a \$700 basis in his ninety shares.

Case 5—*B* sells fifteen shares to *A* for \$450, and *X* then redeems twenty shares from *B* for \$600. *X* Corp. then makes a distribution of \$450 to *A* and \$150 to *B*.

Case 5 increases the complexity of previous cases by combining a sale, redemption, and distribution. Proposed section 300, however, reaches the same result in Case 5 as in the previous cases. The Code in its present form reaches yet another tax configuration whereby *B* has only \$150 ordinary income and \$991.67 capital gains, and *A* has ordinary income of \$450.⁶⁸

As in Case 4, proposed section 300(5) treats the sale as a simultaneous redemption and purchase. On the deemed redemption, the second sentence of proposed section 300(6) compels ordinary income treatment of the proceeds to the extent of earnings and profits attributable to the stock transferred. Proposed section 300(9) allocates \$600 of earnings and profits to *A* and \$600 to *B*. Under proposed section 300(10), \$150 of earnings and profits is attributed to the fifteen shares sold to *A* and is treated as ordinary income by *B*.⁶⁹ Proposed section 300(7) treats the remaining sales proceeds of \$300 as follows: \$25 is a recovery of basis and \$275 represents capital gain.⁷⁰ *A* takes a \$450 basis in the purchased shares under I.R.C. section 1012 and has an overall basis at this point of \$550 in his seventy-five shares. *B* has a basis of \$75 in his remaining forty-five shares.

On the redemption, there is a two-step calculation. First, there is a deemed pro rata distribution. Second, *A* is deemed to contribute his deemed distribution to the capital of *X* which uses the contribution to redeem the twenty shares of *B*. Proposed section 300(4) compels pro rata treatment. *A*, who after the purchase owns sev-

68. See Case 5 *supra* p. 4.

69. Under the formula of proposed § 300(10), *B*'s stock ownership, valued at \$1,800 prior to the sale, decreases to \$1,350 following the sale. *B*'s percentage decrease is \$450/\$1,800 or 25%. Therefore, the portion of *B*'s ratable share of earnings and profits attributable to the 15 shares sold is 25% × \$600, or \$150.

70. Under the formula of proposed § 300(8), the basis allocated to the 15 shares sold equals: \$100 total basis × $\frac{\$450 \text{ decrease in ownership}}{\$1,800 \text{ original ownership}}$ = \$25.

enty-five of 120 shares outstanding, is deemed to receive \$375, and *B* the remaining \$225.⁷¹ Because *A*'s ratable share of earnings and profits under proposed section 300(9) is \$600, the entire \$375 will be ordinary income to him in accordance with proposed section 300(6). *B*'s ratable share of earnings and profits following the shares has been reduced to \$450, which still renders his \$225 deemed distribution ordinary income.

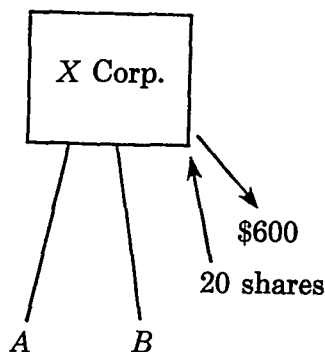
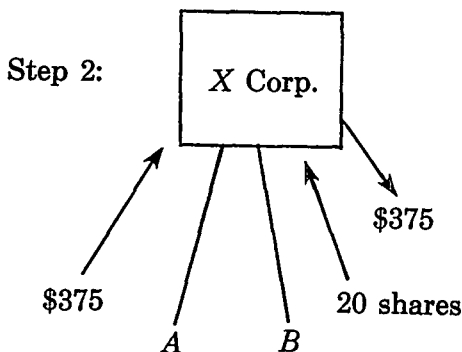
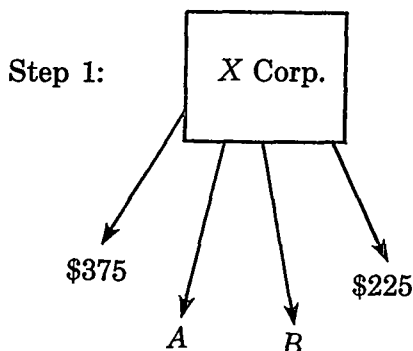
The second step of the redemption under the proposal is a simultaneous contribution to capital and redemption as provided in the second sentence of proposed section 300(5). On the contribution to capital, *A* increases his existing \$550 basis in his *X* stock by \$375 to \$925.⁷² On the simultaneous redemption, *B* receives \$375 for the twenty shares redeemed. Proposed section 300(6) requires ordinary income treatment to the extent of the earnings and profits attributable to the stock transferred. Under proposed section 300(10), the ordinary income component is \$75.⁷³ Proposed section 300(7) addresses the treatment of the additional \$300 of proceeds deemed distributed on the redemption. In accordance with proposed section 300(8), \$25 is a nontaxable recovery of basis and \$275 is a capital gain.⁷⁴ *B* is left with a basis of \$50 in his remaining twenty-five shares. The two-step calculation of the redemption under the proposal can be compared with existing treatment and illustrated as follows:

71. *A* should receive $75/120$ of the \$600 deemed distribution, or \$375. *B* should receive $45/120 \times \$600$, or \$225.

72. See *supra* note 64.

73. Conceptually, *B*, who started Case 5 with \$600 as his ratable share of earnings and profits and has accounted for \$150 on the sale and \$225 on the deemed pro rata distribution arising out of the redemption, is left with \$225 of earnings and profits. *B*'s stock ownership immediately following the deemed distribution and prior to the redemption aspect was valued at \$1,125 (45 shares valued at \$1,350 minus the \$225 deemed distribution). Following the redemption, *B*'s 25 shares were valued at \$750. The \$375 decline in value is a 33.33% decrease. Accordingly, $33.33\% \times \$225 = \75 of earnings and profits are attributable to the stock redeemed.

74. Under the formula of proposed § 300(8), *B*'s stock ownership before the redemption was valued at \$1,125 and afterwards at \$750. *B* thus experienced a 33.33% decrease $\left(\frac{\$375}{\$1,125} \right)$ in his \$75 basis. See *supra* note 73.

EXISTING LAWPROPOSAL

The need for the two-step analysis arises from the recognition that, to the extent that the fair market value of A's stock ownership does not decline as a result of the \$600 paid out by X Corp., A has realized a benefit in the form of increased proportionate participation in X Corp.

Finally, pro rata distributions are made to A and B, A owning seventy-five shares receiving \$450, and B owning twenty-five shares receiving \$150. Under proposed sections 300(6) and (9), computation of the ratable share of earnings and profits for A and B is necessary. X's earnings and profits account following the redemption is \$375. B's ratable share is \$150, and A's ratable share is

\$225.⁷⁵ On the distribution then, *B* treats all \$150 as ordinary income as directed by proposed section 300(6), resulting in a basis of \$50 in his remaining twenty-five shares. *A* must treat \$225 as ordinary income, and the excess distribution of \$225 reduces his \$925 stock basis to \$700 in accordance with proposed section 300(7).

In sum, *B* has \$600 ordinary income (\$150 on the sale, \$300 on the redemption, and \$150 on the distribution), and \$550 capital gains (\$275 on the sale and \$275 on the redemption). *A* must recognize \$600 ordinary income (\$375 on the redemption and \$225 on the distribution). *B* is left with a basis of \$50 in his 25% stock interest in *X*, while *A* has a \$700 basis in his 75% interest.

C. Application of Proposed Section 300: Nonconvertible Preferred Stock.

The analysis thus far has focused solely on cases in which only common stock is outstanding. For the most part, the prior analysis has centered on distributions and redemptions presently covered by I.R.C. sections 301 and 302 respectively. By considering the effects of distributions of preferred stock and on preferred stock, proposed section 300 also addresses issues that I.R.C. section 305 presently attempts to resolve.⁷⁶ The application of proposed section 300 points out some of the inadequacies and confusion haunting the existing statute.

The central provision of proposed section 300 relevant to stock dividends is the last sentence of section 300(4) which provides for tax consequences on a distribution of the distributing corporation's stock only when the receiving shareholders increase their proportionate interests in the distributing corporation. Distributions that do not alter proportionate interests are ignored for tax purposes in

75. Of *A* and *B*'s original \$600 ratable share of earnings and profits, *B* has recognized \$150 on the sale and \$300 on the redemption. *A* has recognized \$375 on the redemption.

76. For a discussion of I.R.C. § 305, see generally Andrews & Wilson, *Stock Dividend Taxation Under the Tax Reform Act of 1969: Expansion of An Ominous Past*, 13 ARIZ. L. REV. 751 (1971); Bashian, *Stock Dividends and Section 305: Realization and the Constitution*, 1971 DUKE L. REV. 1105 (1971); Del Cotto & Wolf, *The Proportionate Interest Test of Section 305 and the Supreme Court*, 27 TAX L. REV. 49 (1971); Metzger, *The "New" Section 305*, 27 TAX L. REV. 93 (1971); Stone, *Back to Fundamentals: Another Version of the Stock Dividend Saga*, 79 COLUM. L. REV. 898 (1979).

keeping with the logic of *Eisner v. Macomber*,⁷⁷ even if a new quality of stock interest is received.

For ease of analysis, a valuation model similar to that used above is illustrative: X Corp. has shareholders A and B. X Corp. was formed with \$2,400 of assets which are expected to produce \$240 of earnings annually, capitalized at a 10% rate by A and B. In year one, X unexpectedly has earned \$1,200 rather than \$240. X Corp. makes the following distributions on December 31:⁷⁸

Case 6—A and B each owns sixty shares of common stock with a basis of \$100. A receives 10% preferred stock worth \$1,200; B receives \$1,200 cash.

Case 7—Stock ownership as in Case 6. A receives 10% preferred stock worth \$1,200; B receives 120 shares of common stock worth \$1,200.

Case 8—A owns sixty shares of common worth \$900 and B owns thirty shares of 10% preferred worth \$1,500 on January 1 of year one. A receives sixty shares of common stock; B receives nothing.

Case 9—Stock ownership as in Case 8. B receives \$150 of common; A receives nothing.

Case 10—Stock ownership as in Case 8. A receives 10% preferred stock worth \$1,050; B receives \$150.

Case 11—Stock ownership as in Case 8. A receives 10% preferred stock worth \$1,050; B receives ten shares of common stock worth \$150.

Case 12—Stock ownership as in Case 8. A receives nothing; B receives 10% preferred stock worth \$150.

Case 13—Stock ownership as in Case 8. A receives sixty shares of common stock; B receives 10% preferred stock worth \$150.

The tax consequences under proposed section 300 and existing law will be considered together.

Case 6—A and B each owns sixty shares of common stock with a basis of \$100. A receives 10% preferred stock worth

77. 252 U.S. 189 (1920).

78. In all cases, it is assumed that the preferred stock is cumulative and nonparticipating. Although the proposal applies to all types of stock interests, the valuation of the distribution and the allocation of earnings and profits to noncumulative and/or participating stock may be more difficult.

\$1,200; *B* receives \$1,200 cash.

In Case 6, immediately prior to distribution, *A* and *B* each owns stock with a fair market value of \$1,800.⁷⁹ Following the distribution, *A* and *B* each owns common stock with a fair market value of \$600, and *A* owns preferred stock worth \$1,200.⁸⁰ The tax consequences under both existing law and proposed section 300 are identical to those described above in Case 1.⁸¹ The only difference between proposed section 300 and I.R.C. section 305(b)(2) is in the capital gains component. Neither *A* nor *B* has any gain as a result of the pro rata stock distribution as mandated by proposed section 300(4). As a consequence of the hypothetical pro rata distribution followed by *A*'s purchase of *B*'s preferred stock, *B* can offset only \$50 of his \$100 basis rather than the full amount which is presently allowed under I.R.C. section 301(c)(2).⁸² Accordingly, *B*'s capital gain on the deemed sale under the proposal is \$550. *A* and *B* each has a \$50 basis in his common stock, and *A* has a \$650 basis in his preferred stock.

Case 7—Stock ownership as in Case 6. *A* receives 10% preferred stock worth \$1,200; *B* receives 120 shares of common stock worth \$1,200.

I.R.C. section 305(b)(3) was enacted specifically to make this type of transaction taxable.⁸³ Moreover, *A* and *B* are taxed even

79. On January 1, there were expected earnings of \$2 per share $\left(\frac{\$240 \text{ earnings}}{120 \text{ shares outstanding}} \right)$

which were capitalized at 10%, providing a \$20 per share fair market value. See *supra* note 20. During the course of the year, *X* Corp. earned an additional \$1,200 available for distribution or \$10 per share. Accordingly, as of December 31, *A* and *B* each held 60 shares worth \$30 or \$1,800.

80. The distribution of \$1,200 decreases the value of the outstanding 120 shares by \$10 per share. In addition, the distribution of the preferred commits \$1,200 of *X*'s assets to the preferred shares, thereby decreasing the value of the common by an additional \$10 per share.

81. See *supra* pp. 19-20. Under I.R.C. §§ 305(b)(2) and 301, *A* and *B* each has \$600 of ordinary income and \$500 capital gain. *A* ends up with a \$1,200 basis in the preferred stock and, like *B*, a \$0 basis in the common.

82. See I.R.C. § 307 for the allocation of basis to the stock received in the deemed pro rata distribution.

83. I.R.C. § 305(b)(3) was enacted to shore up § 305(b)(2). Congress was concerned that a distribution of preferred stock in lieu of cash to some common shareholders while other common shareholders received additional common stock would circumvent § 305(b)(2), because preferred stock is not "property" within the meaning of § 317. See H.R. REP. No. 413

though there is no proportionate increase in the ownership of *X Corp.*⁸⁴ The result under existing law is contrary to the logic of *Eisner*.⁸⁵ All *X* has done is distribute more pieces of paper to *A* and *B*; they own exactly what they owned just prior to the distribution. Had *X* distributed \$1,200 of common stock to *A* and *B*, *Eisner* clearly dictates no taxation.⁸⁶ To the extent *Eisner* continues to influence realization, the fact that *B* receives preferred instead of common should be irrelevant. It should not matter that the preferred stands ahead of the common for purposes of dividends or in the event of liquidation. Nor should it matter that the common carries with it the right to vote. These and other qualitative differences between classes of stock are valued by the market, and all such differences presumably are reflected in the valuation of the stock. For example, the "preference" aspect of the stock may result in a lower discount rate than otherwise would be the case. Similarly, an increase in expected earnings of a corporation may affect the price of common stock more than nonparticipating preferred. The preoccupation of the Code with the qualitative differences between preferred and common stock is evident throughout I.R.C. sections 305 and 306.⁸⁷

Proposed section 300 is neutral as to the qualities of the stock distributed. Instead, the focus is on fair market value, or the market's assessment of those qualities. The distribution of proportionate amounts of *X Corp.* stock to *A* and *B* has no tax consequences under the second sentence of proposed section 300(4) because neither shareholder increases his ownership in *X* relative to the other shareholder.⁸⁸

(Part 1), 91st Cong., 1st Sess. 113 (1969); S. REP. No. 552, 91st Cong., 1st Sess. 152 (1969).

84. Prior to the distribution, each shareholder owns *X* stock with a fair market value of \$1,800. The \$1,200 of preferred stock is a prior claim on \$1,200 of *X Corp.*'s \$3,600 of total assets. The remaining \$2,400 will produce expected earnings of \$240 which are capitalized at 10% leaving \$2,400 of value to the common shareholders. In order for *B* to receive \$1,200 of common stock, the prior holdings of *A* and *B* each are reduced to \$600 in value when *B* receives 120 additional common shares. Following the distribution, *B* holds 180 shares of common stock worth \$1,800, and *A* holds 60 shares of common stock worth \$600 and preferred stock worth \$1,200.

85. See *supra* notes 37, 38 and accompanying text.

86. *Id.*

87. I.R.C. § 302(b)(2) also is restricted to a qualitative measure of equity ownership—the right to vote.

88. The quality of an equity interest can be misleading. For example, in *Baron v. Allied*

Case 8—*A* owns sixty shares of common worth \$900 and *B* owns thirty shares of 10% preferred worth \$1,500 on January 1 of year one. *A* receives sixty shares of common stock; *B* receives nothing.

Under existing law, there are no tax consequences to *A* or *B*. I.R.C. section 305(b)(2)(B) requires a proportionate increase in ownership, and *A* cannot increase his proportionate ownership because *B* owns preferred shares that are not weakened by the issuance of more common shares.⁸⁹ Proposed section 300(4) reaches the same result, because the distribution is pro rata to the common shareholder, *A*, and does not increase his proportionate interest. Any cash received by *B* would be taxable to him as a pro rata distribution on preferred stock under proposed section 300(4).

Case 9—Stock ownership as in Case 8. *B* receives \$150 of common stock; *A* receives nothing.

I.R.C. section 305(b)(4) clearly will tax *B* on the \$150 fair market value of the common received.⁹⁰ Proposed section 300(4) would allow *B* to receive the \$150 of common stock without tax consequences because the distribution does not increase *B*'s proportionate interest in *X* Corp. Immediately prior to the distribution, *B* owned preferred stock with a total fair market value of \$1,650

Artists Pictures Corp., 337 A.2d 653 (Del. Ch. 1975), both voting common and nonvoting preferred were outstanding. The preferred, however, had contingent voting rights in the event of a specified dividend default. As a result of default, the preferred shareholders were able to select and control the Board of Directors from 1964 through 1974. Thus, regardless of the apparent voting control of the common shareholders, the preferred shareholders ran the corporation. In contrast, *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (1940) presents a situation in which the "preference" of the preferred shareholders was an illusion. The preferred shares had a \$6 annual dividend rate and were redeemable at \$100 plus accumulated dividends. Although dividends had accumulated in excess of \$29 per share, a merger with a wholly owned subsidiary was approved cancelling the arrearages. In upholding the elimination of the arrearages, the court emphasized the power of the majority to alter the preferred contract rights if the terms of the merger were "fair and equitable." The appraisal right granted to the dissenters was deemed to be an adequate remedy. See also *Bove v. Community Hotel Corp.*, 105 R.I. 36, 249 A.2d 89 (1969).

89. See Treas. Reg. § 1.305-3(e), Ex. 2 (1973).

90. Even prior to the 1954 Code, there was never any serious question that distributions of preferred or common on preferred were taxable. See, e.g., *Koshland v. Helvering*, 298 U.S. 441 (1936) (common on preferred); *Messer v. Commissioner*, 20 T.C. 264 (1953) (preferred on preferred). In *Koshland*, the Court emphasized the acquisition of an interest different from that inherent in the shareholder's preferred stock. 298 U.S. at 446.

(\$1,500 fair market value as of January 1 and \$150 for the expected 10% dividend). A's common stock is worth \$1,950 (\$900 fair market value as of January 1 and \$1,050 of earnings available for distribution to A, the common shareholder). If there had been no distribution, *Eisner* would preclude the taxation of either A or B on the mere appreciation. The fact that X distributes additional stock certificates to B to commemorate the appreciation should not change the result. Immediately after the distribution, as immediately before, B owns a stock interest in X worth \$1,650, now represented by preferred stock valued at \$1,500 following the stock distribution and common stock worth \$150. A continues to own common stock with a \$1,950 fair market value. As in Case 7, the fact that a shareholder receives an interest different in quality from his existing interest should be irrelevant to a tax system that is directed at "income." Only fair market value should be determinative.

Although I.R.C. section 305(b)(4) and proposed section 300(4) reach opposite conclusions on the taxability of a common stock dividend equal in value to the dividend expected on the preferred stock, they reach a similar conclusion as to taxability when the common stock dividend exceeds the dividend expected on the preferred stock. The amount of the taxable dividend, however, differs. For example, suppose that instead of \$150 of common stock, X distributes \$300 of common stock to B. Under I.R.C. section 305(b)(4), B would have a \$300 dividend, the fair market value of the distributed stock. Proposed section 300(4) also would tax B, but only to the extent that the pro rata distribution increases B's proportionate interest in X Corp. Immediately prior to the distribution, B held a stock interest valued at \$1,650 while A's interest had a fair market value of \$1,950. Immediately after the distribution, A holds X Corp. stock with a value of \$1,800 (\$1,500 of preferred and \$300 of common), while the value of B's interest has declined from \$1,950 to \$1,800. A has increased his proportionate interest in X Corp. by \$150.⁹¹

To determine the tax consequences of the \$150 proportionate increase, it is necessary to allocate earnings and profits between the

91. In *Koshland*, *supra* note 90, the preferred stock was paid in lieu of the expected cash dividends, yet the Supreme Court held the entire value of the preferred stock to be taxable.

common and preferred stock. Proposed section 300(6) treats the \$150 proportionate increase as ordinary income to the extent of the taxpayer's ratable share of earnings and profits. The \$1,500 of cumulative nonparticipating preferred stock paying a 10% dividend holds a claim on \$150 of earnings and profits in any year. Any earnings and profits in excess of that amount are allocable to the common shares.⁹² This allocation method is currently applied in Treasury Regulations⁹³ for purposes of determining the dividend portion of gain from the sale or exchange of stock in certain foreign corporations. Because of the limitless variations inherent in preferred stock, Treasury Regulation section 1.951-1(c)(3) places the burden of a reasonable allocation method on the taxpayer when the corporation has discretion to allocate the earnings to different classes of stock. In the absence of a reasonable allocation method, all stock will be treated as one class sharing pro rata in the earnings and profits. To restate the principle underlying the application of proposed section 300(4) to Case 9, a distribution of common preferred should be taxable only to the extent the distribution exceeds the value of the expected dividend.⁹⁴

Case 10—Stock ownership as in Case 8. A receives 10% preferred stock worth \$1,050; B receives \$150.

Case 10, like Case 9, focuses on the receipt by some shareholders of a different qualitative interest in the corporation. Here, the

92. If the preferred stock were participating evenly with the common stock in all earnings and profits in excess of the stated dividend, \$675 of earnings and profits would be allocated to the preferred (\$150 stated dividend and \$525 of the remaining \$1,050 of earnings and profits).

93. See Treas. Reg. §§ 1.1248-3(c)(4), T.D. 6779, 1965-1 C.B. 383, 400 amended by T.D. 7545, 1978-1 C.B. 245, 248 and 1.951-1(e)(2), (3) (1965).

94. For the application of the principle in another context, consider Y Corp. valued at \$1,000, owned by A with 10 shares of common and B with 90 shares of common, each share worth \$10. Y distributes a dividend of 10 shares of Y stock to B and \$.01 to A. According to I.R.C. § 305(b)(2), B is taxed on the fair market value of 10 shares or \$90.91

$$\left(\frac{\$1,000 \text{ value of Y}}{110 \text{ shares outstanding}} \times 10 \text{ shares received} \right)$$

even though his total interest in Y after the distribution is \$909.09, only \$9.09 more than before. The correct result should be to tax B on \$9.09, the value of the one additional share received over what would have been a pro rata distribution—one share to A and nine shares to B. That is, if B sells the one additional share, he maintains his original 90% interest in X Corp. Proposed § 300(4) leads to this conclusion.

common shareholder receives preferred. Even prior to the 1954 Code, courts following the proportionate test as evolved in *Helvering v. Sprouse*⁹⁵ and *Strassburger v. Commissioner*⁹⁶ found the stock dividend to be taxable in the Case 10 pattern.⁹⁷ I.R.C. section 305(b)(2) continues this result.⁹⁸ Therefore, *A* would be taxed on \$1,050 ordinary income and *B* on \$150 ordinary income.

This result, however, is unsatisfactory because *A* does not increase his proportionate interest in *X* as measured by the fair market value of his equity ownership immediately before and after the distribution. Immediately prior to the distribution on December 31, *B* holds preferred stock valued at \$1,650 (\$1,500 plus \$150 earnings); *A*'s common stock is worth \$1,950 (\$900 as of January 1 plus \$1,050 of earnings). Immediately after the distribution, *A* continues to possess a \$1,950 interest in *X* Corp. *B* will be taxed on the \$150 cash received, and his stock interest will then be \$1,500. If *A*'s stock dividend has been \$1,050 of common stock rather than preferred, the Code would not tax the dividend.⁹⁹ The result should be no different merely because a different quality of equity ownership is distributed. Again, the fair market value of the equity distribution should govern the tax consequences. Let the market determine the value of the preferred nature of the stock.

The fact that the Case 10 pattern should not result in tax consequences to *A* does not mean that all distributions of preferred on common should be tax-free. The distribution of \$1,050 of preferred stock in Case 10 does not pose a threat to *B*'s existing preferred stock because *X* Corp., with \$3,600 of assets as of December 31, has sufficient assets to cover the value of the stock and to produce earnings sufficient to pay the future dividends. At some point, a distribution of preferred to *A* would dilute the value of *B*'s existing

95. 318 U.S. 604 (1943).

96. *Id.* In *Sprouse*, *supra* note 95, the shareholder owned voting common stock, and a pro rata distribution of nonvoting common stock was made to shareholders of both voting and nonvoting common stock. Although the shareholder received a different type of stock interest, the Supreme Court held that the dividend was not income because there was no change in the shareholder's proportional interest. Similarly, in *Strassburger*, a dividend of preferred on common to the corporation's sole shareholder was not income.

97. See, e.g., *Pizitz v. Patterson*, 183 F. Supp. 901 (N.D. Ala. 1960); *Paper v. Commissioner*, 29 B.T.A. 523 (1933).

98. See Treas. Reg. § 1.305-3(e), Ex. 3 (1973).

99. See *supra* Case 8 at p. 30 and Treas. Reg. § 1.305-3(e), Ex. 2 (1973).

preferred shares, thereby giving *A* a proportionate increase in the value of *X Corp.*¹⁰⁰ To the extent of a shift in proportionality, *A* should be taxable.

Case 11—Stock ownership as in Case 8. *A* receives 10% preferred stock worth \$1,050; *B* receives ten shares of common stock worth \$150.

Case 11 combines aspects of Cases 7, 9, and 10. As in Cases 9 and 10, the shareholders receive a different quality of equity interest than they previously owned. As in Case 7, *A* and *B* each receives a pro rata share of the earnings and profits. Under I.R.C. section 305(b)(4), *B* will be taxed on \$150, the fair market value of the distribution. Because *A* is considered to have increased his proportionate share in *X*,¹⁰¹ I.R.C. section 305(b)(2) is invoked as *B* is considered to have received “property.”¹⁰²

Proposed section 300(4) would give *A* and *B* tax-free treatment of the stock dividends. Both immediately before and after the distribution, *A* owns stock with a \$1,950 fair market value while *B*'s stock is valued at \$1,650. There is no change in proportionate interest.

Case 12—Stock ownership as in Case 8. *A* receives nothing; *B* receives 10% preferred stock worth \$150.

Case 12, like Case 9, is ruled by I.R.C. section 305(b)(4) which taxes *B* on the \$150 fair market value.¹⁰³ Proposed section 300(4) would not tax *B*, who merely receives additional stock certificates

100. For example, if *B* owns 30 shares comprising his \$1,500 of 10% preferred stock, and the dividend to *A* in Case 10 was 60 shares of identical preferred stock, *A* would be taxed to the extent that his proportionate interest in *X* increased above \$1,950. Following the distribution of the stock to *A* and \$150 to *B*, *X Corp.* is valued at \$3,450. Because *A*'s and *B*'s preferred claims exceed the value of *X*'s assets, *A*'s preferred interest entitles him to \$2,311.50 of that value ($.67 \times \$3,450$) while *B*'s interest declines from \$1,500 to \$1,138.50. The common stock declines in value to \$0 because of the preferred claims. Proposed § 300(4) would tax *A* on his \$361.50 proportionate increase in *X* (\$2,311.50 share value after the distribution minus \$1,950 share value prior to the distribution). *B* would be taxed on the \$150 cash dividend.

101. Treas. Reg. § 1.305-3(e), Ex. 3 (1973).

102. I.R.C. § 305(b)(4), in conjunction with the flush language of § 305(b), treats the distribution on preferred as “property,” triggering § 305(b)(2). See Treas. Reg. § 1.305-3(e), Ex. 15 (1973).

103. See Treas. Reg. § 1.305-5(d), Ex. 1 (1973).

representing his appreciation in the X Corp. stock. No shift in proportionate interest has occurred. If B's stock dividend equaled \$300 of 10% preferred stock, proposed section 300(4) would call for a tax on \$150, the disproportionate amount received by B.¹⁰⁴

Suppose instead that no stock dividend was paid, but that B's stock was 10% discount preferred issued on January 1 for \$1,500 and redeemable on December 31 of year two for \$1,815. I.R.C. section 305(c) combines with section 305(b)(4) to tax B on \$150 in year one, a result consistent with the analysis of Case 12 under existing law.¹⁰⁵ Here again, there has been no proportionate shift in the ownership of X, and no immediate tax should result until redemption, at which time there will be ordinary income recognition to B in accordance with proposed sections 300(6) and (7).¹⁰⁶

Case 13—Stock ownership as in Case 8. A receives sixty shares of common stock; B receives 10% preferred stock worth \$150.

Combining Cases 8 and 10, this pattern produces predictable results under both the existing and proposed statutory framework. I.R.C. section 305(b)(4) taxes B on the \$150 fair market value while A escapes unscathed under I.R.C. section 305(a). There would be no tax consequences under proposed section 300(4), because both A and B continue to own stock in X, valued at \$1,950 and \$1,650 respectively, as they did immediately prior to the distribution.¹⁰⁷

D. *Application of Proposed Section 300: Preferred Redemptions*

The impact of a redemption on nonredeeming shareholders was considered above in Case 2 in which only common stock was out-

104. B has increased his ownership interest from \$1,650 immediately prior to the distribution to \$1,800 immediately after, while A's interest has decreased from \$1,950 to \$1,800 for the same period.

105. See Treas. Reg. § 1.305-5(b) (1973), which mandates a constructive distribution to the extent the redemption premium is not "reasonable." See also *id.* at § 1.305-5(d), Exs. 7, 8 (1973). For a critical evaluation of the treatment of discounted preferred stock, see Note, *Discounted Preferred Stock Under the New Section 305 Treasury Regulations: On Confusing Debt and Equity*, 84 YALE L.J. 324 (1974).

106. See *infra* pp. 36-37 for a discussion of preferred stock redemptions.

107. The value of the 60 shares of common distributed to A is \$975. The value of his original 60 shares decreases from \$1,950 to \$975 to reflect the additional shares distributed.

standing.¹⁰⁸ The analysis is applicable to redemptions of preferred stock as well. When preferred stock is redeemed, it is the remaining common shareholders who increase their proportionate interest in the corporation.¹⁰⁹ Although isolated redemptions do not cause tax consequences to the nonredeeming shareholders under I.R.C. section 305,¹¹⁰ tax consequences result under proposed section 300. Again, X Corp., with a value of \$3,600 including \$1,200 of earnings and profits, is used as a model:

Case 14—A owns common stock worth \$900 when issued on January 1 and \$1,950 on December 31. B owns 10% preferred stock worth \$1,500 when issued on January 1 and \$1,650 on December 31. At year end, X redeems \$1,200 worth of B's stock.

Under existing law, I.R.C. section 302(b)(1) is likely to give B a \$109.09 capital gain.¹¹¹ A will have no tax consequences.¹¹² In contrast, proposed section 300 will cause both A and B to recognize ordinary income on the redemption. Proposed section 300(4) treats the \$1,200 paid by X as a pro rata distribution to B and A, whose interests in X increase due to the redemption.¹¹³ If X merely had distributed \$1,200 to B not in redemption, A's stock would have declined in value from \$1,950 to \$900.¹¹⁴ Because preferred shares of B are surrendered in exchange for the \$1,200 distributed, A's

108. See *supra* pp. 20-22.

109. See *supra* note 49.

110. See Rev. Rul. 78-115 1978-1 C.B. 85. See also *supra* note 12.

111. See Treas. Reg. § 1.302-2(a) (1960); Rev. Rul. 77-426, 1977-2 C.B. 87 (redemption of any nonvoting, nonconvertible, nonparticipating preferred is meaningful if the shareholders own no common directly or indirectly). Assuming no portion of the \$1,200 is deemed to be a dividend to B, B's capital gain will be

$$\$1,200 - \left(\frac{\$1,200}{\$1,650} \times \$1,500 \text{ basis} \right) = \$109.09.$$

See *Bittker & Eustice, supra* note 32, at ¶ 9.61 for a discussion of possible dividend consequences to a redeeming shareholder where the amount received exceeds the value of the share surrendered. B's basis in his remaining \$450 of stock will be

$$\$1,500 - \left(\frac{\$1,200}{\$1,650} \times \$1,500 \right) = \$409.09.$$

112. See *supra* note 12.

113. See *supra* note 49.

114. X Corp., after a \$1,200 distribution, would have \$2,400 of assets to which B and A would have preferred claims of \$1,500 and \$900 respectively.

stock increases in value from \$900 to \$1,950. Proposed section 300(4), therefore, treats *A* as having received a distribution of \$1,050 and *B* as having received \$150. The deemed distributions are taxed as ordinary income pursuant to proposed sections 300(6) and (9). Following the deemed distribution, proposed section 300(5) treats *A* as contributing his \$1,050 deemed distribution to *X*, thereby increasing his stock basis from \$900 to \$1,950.¹¹⁵ Simultaneously, *B* is deemed to receive \$1,050.¹¹⁶ Because *B* has accounted for his ratable share of earnings and profits on the deemed distribution, proposed section 300(7) treats the \$1,050 as a reduction of the \$1,050 basis in the stock exchanged, leaving *B* with preferred stock having a basis and fair market value of \$450. *A* holds common stock with a basis and fair market value of \$1,950. In effect, *B* is treated as though he received his \$150 dividend and redeemed \$1,050 of his original \$1,500 of preferred stock.¹¹⁷

E. *Application of Proposed Section 300: Convertible Preferred*

Finally, distributions of convertible preferred and nonconvertible preferred would be treated in a different manner under proposed section 300 than under current law. I.R.C. sections 305(b)(5) and 301 tax most distributions of convertible preferred, because some shareholders may convert and others will keep the preferred.¹¹⁸ No effort is made by proposed section 300 to assess the

115. See I.R.C. § 118; Treas. Reg. § 1.118-1 (1960).

116. Immediately after the deemed distribution and prior to the redemption, *B*'s stock was valued at \$1,500. Following the redemption, *B* held \$450 of preferred stock (he started with \$1,650 of stock of which \$1,200 was redeemed). Thus, *B*'s ownership declined by $\frac{\$1,500 - \$450}{\$1,500} = 70\%$. On the redemption, proposed § 300(8) allocates $70\% \times \$1,500$ basis = \$1,050 to the preferred shares surrendered.

117. *A* will be taxed on \$1,050 without receiving any cash. He can, however, sell \$1,050 of stock at no gain without decreasing his equity ownership in *X* Corp. Originally, *A* owned stock worth \$900, or 37.5% of *X* Corp.'s \$2,400 value. *X* then earned \$1,200 which was used to redeem *B*'s stock, increasing *A*'s stock value to \$1,950. If *A* sells \$1,050 of his stock, he will then return to his 37.5% share of equity ownership.

118. See Treas. Reg. § 1.305-6 (1973). The statutory presumption can be overcome when the conversion right may be exercised over a period of many years. It should be noted that any distribution of convertible preferred on outstanding preferred is taxable under I.R.C. § 305(b)(4) regardless of the likelihood of convertibility. If the distribution is on common stock, § 305(b)(5) serves to prevent an end-run around § 305(b)(3) if some shareholders convert and some do not. See generally Metzger, *supra* note 76, at 136-38.

likelihood of conversion. Moreover, the fact that some shareholders may end up with common while others keep the preferred is irrelevant. The fair market value of the stock serves as the measure of the desirability of various equity features. As long as the distribution of the convertible preferred does not change a shareholder's proportionate interest in *X Corp.*, the distribution should not be taxed.¹¹⁹

Distributions on convertible preferred and on common when convertible preferred is outstanding can alter proportionate interests of the shareholders. For example, if common shareholders receive cash and convertible preferred shareholders increase their conversion ratio, I.R.C. section 305(b)(2) will tax the preferred shareholders on the value of the additional conversion rights as measured by the value of the additional common shares assuming full conversion.¹²⁰ The primary difficulty with existing treatment of convertible preferred lies in the valuation of increased and decreased conversion rights.

For purposes of illustration, *X Corp.* has shareholder *A* who owns sixty shares of common with a fair market value of \$900, and shareholder *B* who owns 8% preferred stock with a fair market value of \$1,500 which is convertible into sixty shares of common. *X Corp.* has ample earnings and profits. Without the conversion privilege, 8% preferred stock would have a fair market value of \$1,200; the excess \$300 represents a conversion premium.¹²¹

Case 15—*X* distributes \$1 to *B* and decreases the conversion ratio to thirty shares.

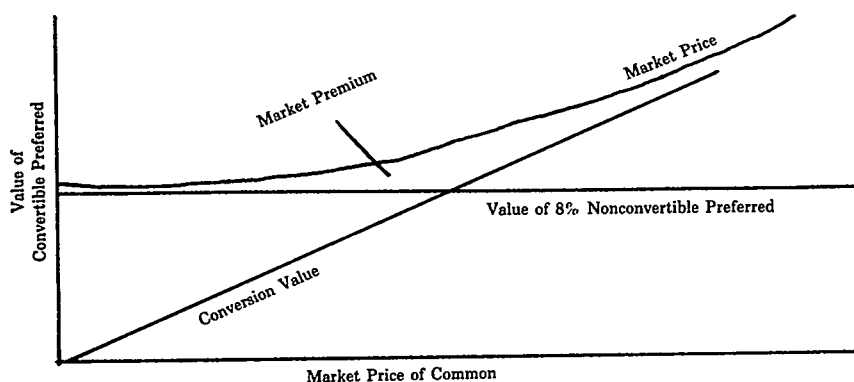
In accordance with the regulations under I.R.C. section 305(b)(2), *A* probably would be taxed on \$800 by virtue of *B*'s re-

119. See Case 7 *supra* pp. 28-30.

120. See Treas. Reg. § 1.305-3(e), Exs. 6, 7 (1973). Treas. Reg. § 1.305-3(d) (1973) allows an increase in conversion ratio that serves to adjust for a stock dividend on the residual common shares. See Treas. Reg. § 1.305-3(e), Ex. 5 (1973).

121. The market price of a convertible instrument has been described by the following illustration:

duced conversion privilege.¹²² The regulations attempt to analyze A's tax position assuming full conversion. With that assumption, A has increased his ownership percentage to 66.67% (sixty out of ninety shares) following the conversion ratio reduction. The amount of A's distribution is measured by the fair market value of the number of shares which would have been distributed to A had X sought to increase A's ownership percentage from his original 50% to 66.67%. This deemed sixty share distribution would have a total fair market value of \$800.¹²³ This result not only ignores any decrease in value of A's original sixty shares contrary to *Eisner v. Macomber*,¹²⁴ but also ignores the fact that A's stock value can increase only by a \$300 maximum as a result of a change in B's conversion ratio. Even if B's conversion privilege were totally eliminated, the unadorned 8% preferred would have a \$1,200 fair market value, leaving a maximum of \$1,200 value for the common



See MAO, CORPORATE FINANCIAL DECISIONS 413 (1976); VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 604 (4th ed. 1977); See generally Quandt, Malkiel & Bauml, *The Valuation of Convertible Securities*, THEORY OF BUSINESS FINANCE (Weston and Woods ed. 1967); Walter & Que, *The Valuation of Convertible Bonds*, 28 J. OF FINANCE 713-32 (1973).

The premium over both the straight preferred price and the conversion value is justified by the floor that the preferred offers, severely curtailing any downside risk. See VAN HORNE, *supra* at 603-07.

122. See Treas. Reg. § 1.305-3(d), (e), Exs. 6-8 (1973).

123. Treas. Reg. § 1.305-3(e), Ex. 8 (1973). The original 120 shares, assuming full conversion, had a \$2,400 fair market value, or \$20 per share. Following the deemed distribution of an additional 60 shares, each share has a fair market value of \$13.33.

124. 252 U.S. 189 (1920).

compared with its preconversion ratio adjustment value of \$900.¹²⁵

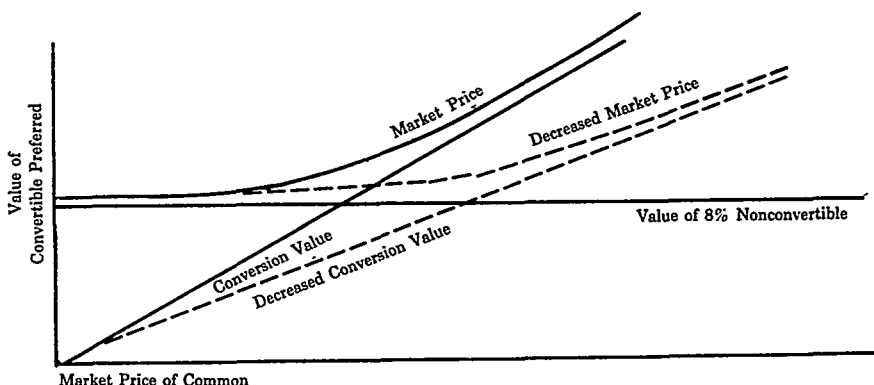
Proposed section 300 does not resolve the valuation difficulties but aims at a theoretically correct valuation. Proposed section 300(2) in conjunction with section 300(1) must be read to include a constructive stock payment to A when B's conversion ratio is reduced. As B's conversion ratio decreases, the value of the convertible preferred decreases to somewhere between \$1,200 and \$1,500¹²⁶ while the value of A's common increases accordingly. The precise increase in value to A is difficult to measure. Logically, the increase cannot exceed the decline in value to B, assuming the conversion privilege is fully eliminated. The burden should be on A to show any lesser increase in value.

Case 16—X distributes \$1 to A and increases the conversion ratio to ninety shares.

The regulations interpreting I.R.C. section 305(b)(2) would tax B on the value of the additional thirty shares assuming full conversion.¹²⁷ B presumably would be deemed to receive a \$480 distribu-

125. Even under the method prescribed by the regulations, A should not have an \$800 increase in value. Prior to the deemed 60 share distribution, A had a stock value of \$1,200 assuming full conversion, and after the distribution the value was \$1,600 (two-thirds of the total \$2,400 value). Accordingly, the distribution under the full conversion method cannot exceed \$400. The \$800 computation produced by Example 8 of Treas. Reg. § 1.305-3(e) ignores the decrease in value of A's original 60 shares from \$1,200 to \$800 in contravention of the reasoning in *Eisner*, *supra* note 124.

126. The decline in value of the convertible preferred can be pictured as follows:



127. See Treas. Reg. § 1.305-3(e), Ex. 6 (1973).

tion.¹²⁸ If there is full conversion, however, *B*'s proportionate increase in *X* Corp. will not exceed \$240.¹²⁹ To tax *B* on the fair market value of the deemed thirty share distribution and not take into account the dilution in value of *B*'s existing shares is out of step with *Eisner v. Macomber*.¹³⁰ Conceivably, if the premium on the convertible preferred increases or decreases as the conversion ratio increases, the gain to *B* might be more or less than \$240; but, in the absence of proof to the contrary, the increase in proportionate interest upon full conversion is a reasonable and administratively workable measure.¹³¹

III. EFFECT OF PROPOSED SECTION 300 ON EXISTING PROVISIONS

A. I.R.C. Sections 301, 302, and 305

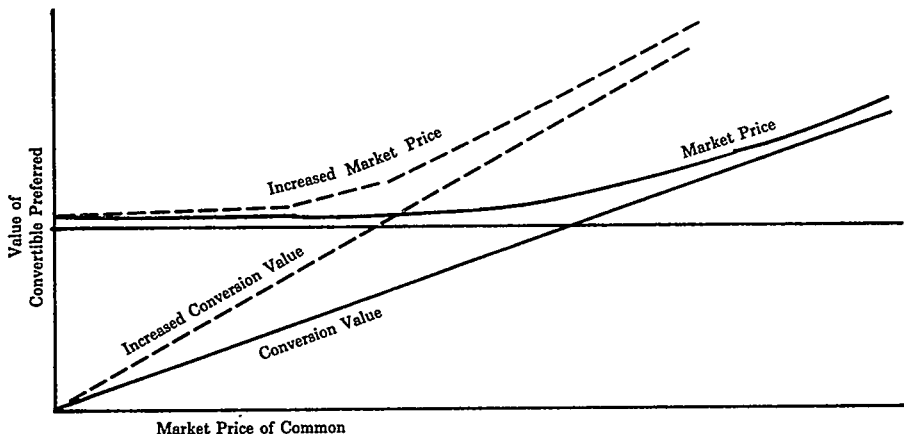
Proposed section 300 attempts to unify the treatment of stock dividends, nonstock dividends, and redemptions. The taxing regime of I.R.C. section 301(c) is central to the proposal. By unifying

128. Under full conversion following the adjustment, there would be 150 shares outstanding to share in *X*'s \$2,400 value. Each share would be worth \$16. *B* is deemed to receive 30 shares with a fair market value of \$480 as a result of the increased conversion ratio.

129. Prior to the change in conversion ratio, *B*'s interest in *X* is \$1,200 fully converted. After the change, *B* would hold 90 out of 150 shares, or $90/150 \times \$2,400$ value of *X* = \$1,440. See *supra* note 125.

130. *Supra* note 124.

131. The rise in value of the convertible preferred can be pictured as follows:



the treatment of these transactions, proposed section 300 would eliminate any resort to computing artificial percentage reductions in I.R.C. section 302(b)(2). At stake under existing law is the difference between treating all redemption proceeds as capital gains to the extent they exceed the basis of the redeemed stock and treating the proceeds as ordinary income assuming there are sufficient earnings and profits. It is an all or nothing provision. Proposed section 300 does not concern itself with percentage reductions, but rather recognizes that a redemption might have both an ordinary income and capital gains component.¹³² A shift in focus from the arbitrary 50% and 80% tests to a determination of the ordinary and capital gains components is more satisfying on a theoretical level and would eliminate the need for litigation and administrative rulings, the sole concern of which is percentage reduction of ownership.¹³³

I.R.C. section 302 is inseparable from the attribution rules of I.R.C. section 318.¹³⁴ In the context of section 302, the attribution rules prevent shareholders from apparently qualifying for capital gains treatment while indirectly retaining percentage ownership in the corporation that belies any meaningful reduction.¹³⁵ For example, A and B, father and son and sole owners of X Corp., each own sixty shares worth \$1,800 with a basis of \$120. X, with \$1,200 of earnings and profits, redeems thirty shares from A for \$900. In the absence of the attribution rules, A would satisfy the percentage requirements of I.R.C. section 302(b)(2) and be entitled to capital gains treatment.¹³⁶ However, by virtue of attribution, A is deemed

132. Sprinkled throughout the Code are provisions that bifurcate gain into ordinary income and capital gains components. Cf. I.R.C. § 1237 (treating 5% of the sales price of certain subdivided property as ordinary income and the remainder as capital gain); I.R.C. § 631 (treating appreciation in standing timber as capital gain when the timber is cut, and profits in selling the cut timber as ordinary income).

133. Much of the litigation and administrative activity is aimed at satisfying the "not essentially equivalent to a dividend" requirement of I.R.C. § 302(b)(1) by showing a meaningful reduction. See cases and rulings cited by BITTKER & EUSTICE, *supra* note 32, at ¶ 9.24 nn.70-72.

134. See I.R.C. § 302(c).

135. For a general discussion of the attribution rules, see BITTKER & EUSTICE, *supra* note 32, at ¶ 9.31; Goldstein, *Bringing the Attribution Rules Into Sharper Focus; How and Where They Apply*, 26 J. TAX'N 280 (1967); Ringel, Surrey & Warren, *Attribution of Stock Ownership in the Internal Revenue Code*, 72 HARV. L. REV. 209 (1958).

136. A owns 50% before and 33.33% after the redemption, less than 80% of his original

to own all of the shares actually owned by *B*, and consequently, *A* owns 100% of *X* before and after the redemption.¹³⁷ The result is apparently \$900 of ordinary income to *A*.¹³⁸ Again the "all or nothing" philosophy of I.R.C. section 302 makes attribution crucial.

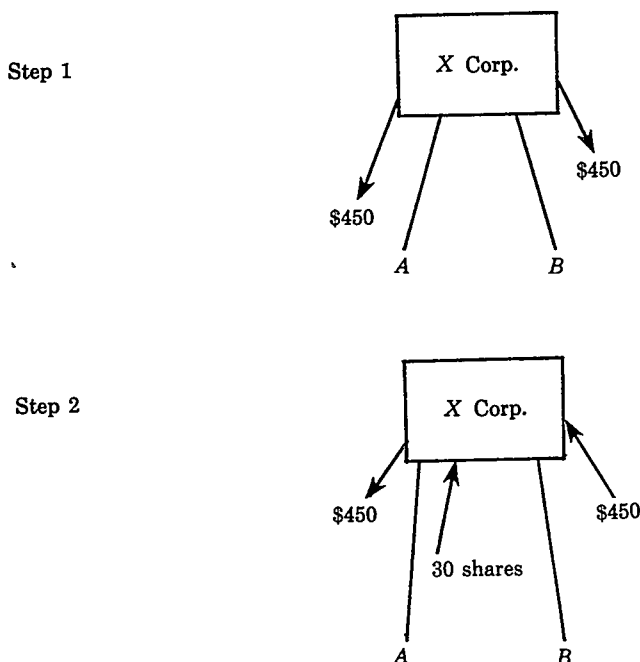
By contrast, proposed section 300 does not embrace an "all or nothing" concept. Without attribution under proposed section 300(4), *A* and *B* each would be deemed to receive a \$450 distribution which would be ordinary income under proposed section 300(6). *A* would have an additional \$50 ordinary income, \$360 capital gain and \$40 return of basis on the redemption aspect of the transaction pursuant to proposed sections 300(5), (8), and (10).¹³⁹

ownership. *A* would have an \$840 capital gain and a \$60 return of basis.

137. See I.R.C. §§ 302(c)(1), 318(a)(1)(A)(ii).

138. See I.R.C. §§ 301, 302(d). Compare I.R.C. § 316 (no allocation of earnings and profits on a pro rata basis among shareholders) with I.R.C. §§ 333(e), 356(a)(2) (pro rata allocation).

139. The entire redemption can be illustrated:



Immediately after the deemed distribution and prior to the hypothetical redemption, *A*'s

To the extent that attribution is intended to recognize the unity of certain multiple stock interests, \$450 of ordinary income to *B* must be considered disadvantageous to *A*. This should follow from the fact that the attribution rules regard *B*'s ownership as a distinct advantage to *A*—indeed to be owned by *A*. Therefore, under proposed section 300, without attribution, the total ordinary income recognized by the *A-B* family is \$950 as well as the \$360 capital gain. The need to attribute *B*'s ownership to *A* in order to prevent avoidance of ordinary income treatment does not exist under proposed section 300.¹⁴⁰ Recognition of gain by the nonredeeming shareholders solves the attribution problem by penalizing the redeemer only when a unity of relationship exists. This approach is a sound step away from relying on the artificiality of the specified categories set forth in I.R.C. section 318, which in fact may not always identify any unity of relationship with the redeemer.¹⁴¹

Similar problems of artificiality in I.R.C. section 305 are addressed by proposed section 300. No logic supports a provision under which if *A* and *B* are common stock shareholders and *A* receives a preferred stock dividend, his tax consequences hinge on whether *B* receives at least one dollar. If *B* does receive a dollar, I.R.C. section 305(b)(2) will tax *A*; if not, section 305(b) does not apply and the receipt of the preferred stock will not be a taxable event.¹⁴² Similarly, if *A* receives preferred stock and *B* receives common stock with no change in their proportionate economic in-

stock had a \$1,350 fair market value. After the redemption, *A* continued to hold 30 shares valued at \$900. When this 33.33% decrease in ownership is applied to *A*'s \$150 ratable share of earnings and profits remaining after the deemed distribution, \$50 will produce ordinary income under proposed §§ 300(6) and (10). When the 33.33% decrease in ownership is applied to *A*, \$120 is basis pursuant to proposed § 300(8), and \$40 of the basis is consumed on the redemption. The remaining \$360 is a capital gain. See proposed § 300(7) *supra* p. 16.

140. Indeed, if proposed § 300 incorporated the attribution concept, the *A-B* family would be better off, ending up with only \$900 of ordinary income and no capital gain. Because more ordinary and total income will be recognized under proposed § 300 when there is no attribution than when attribution exists, there will be no incentive to use family or business relationships to manufacture redemptions out of distributions, except to the extent that attributable family or business shareholders are in lower tax brackets.

141. For unsuccessful attempts to escape the attribution rules through an assertion of family discord, see *David Metzger Trust*, 76 T.C. 42 (1981); Rev. Rul. 80-26, 1980-1 C.B. 66.

142. The receipt is not a taxable event, because I.R.C. § 305(b)(2)(A) requires the receipt of "property" by shareholders not increasing their proportionate interests. Presumably, the preferred stock would be treated as "section 306 stock" under I.R.C. § 306(c).

terests in the corporation, why should there be any immediate tax consequences solely because of the qualitative differences in the stock received? Proposed section 300 seeks to ignore the qualitative differences of distributions in favor of the market assessment of those differences.

Another illogical feature of I.R.C. section 305 is the fact that only some redemptions trigger recognition of income by the remaining shareholders.¹⁴³ Indeed, the more significant the redemption, and hence the more significant the proportionate gain by the remaining shareholders in the corporation, the less the likelihood of taxation to the remaining shareholders. By equating a redemption with a pro rata distribution followed by a purchase between shareholders, proposed section 300 recognizes the benefits to the remaining shareholders in all redemption situations, including particularly significant redemptions that under existing law would qualify under I.R.C. section 302(a).

Applying the attribution rules under I.R.C. section 318 to redemptions but not to stock dividends presents another incongruity under existing law.¹⁴⁴ If *A* and *B*, father and son, own preferred and common respectively, and *A* receives a common stock dividend, I.R.C. sections 302(b)(4) and 301 combine to tax *A*. If, instead, *A*'s stock was redeemed, in determining whether capital gains treatment under I.R.C. section 305(b)(2) was appropriate, *A* would be saddled with *B*'s ownership in accordance with I.R.C. section 318(a)(1)(A). If *A* constructively is deemed to own *B*'s shares for redemption purposes, *A* should be deemed to own 100% of the corporate stock for stock dividend purposes, thereby rendering the receipt of common stock by *A*, a 100% shareholder through constructive ownership, tax-free under *Eisner v. Macomber*.¹⁴⁵ By recognizing the relationships between both stock and nonstock dividends and redemptions, proposed section 300 would eliminate much of the artificiality of I.R.C. sections 302 and 305, thus leaving problems of valuation as the focal point of analysis.

143. I.R.C. §§ 305(c) and (b)(2) can combine to tax the remaining shareholders on redemptions, but Treas. Reg. § 1.305-3(c), Exs. 10, 11, 13 (1973) limits the taxation to "isolated redemptions." See Rev. Rul. 77-19, 1977-1 C.B. 83.

144. See Rev. Rul. 78-60, 1978-1 C.B. 81.

145. 252 U.S. 189 (1920).

B. I.R.C. Section 304

The fact that a sale engenders capital gains treatment while a pro rata redemption results in ordinary income treatment originally spawned the need for the predecessors to I.R.C. section 304.¹⁴⁶ If A owns all of the stock of X Corp., the parent of Y Corp., a wholly owned subsidiary, and A sells some of his X stock to Y at a profit, capital gains treatment would result on the sale in the absence of any remedial provision.¹⁴⁷ Even though corporate funds were distributed to the shareholder in exchange for stock, I.R.C. section 302 analysis would not apply because Y does not redeem "its stock" as the statute requires. If I.R.C. section 302 were applicable, A, as a 100% shareholder both before and after the transaction, would not be protected by the safe harbors of I.R.C. section 302(b), and dividend treatment would result under I.R.C. section 301(c) to the extent of earnings and profits. To prevent circumvention of the section 302(b) tests, Congress enacted an intercorporate redemption provision that, in its present form, applies to both brother-sister and parent-subsidary corporations.

Under I.R.C. section 304(a)(1), if one or more persons are in control of each of two corporations, the transfer of stock in one corporation by a shareholder to the other corporation is treated as a capital contribution of the stock of the issuing corporation to the acquiring corporation followed by a redemption of the stock of the acquiring corporation which must withstand the rigors of I.R.C. section 302(b). In applying the section 302 tests to the deemed redemption, I.R.C. section 304(b)(1) directs that the stock of the issuing corporation should be used as a reference, but that the earnings and profits of the acquiring corporation serve as the measure of ordinary income if the redemption falls under I.R.C. section 301(c).

In the parent-subsidary context, I.R.C. section 304(a)(2) treats the sale of the parent's stock held by a shareholder to a subsidiary as a redemption by the parent which must sail through one of the

146. See I.R.C. § 115(g) (1939). For a thorough analysis of I.R.C. § 304, see Marans, *Section 304: The Shadowy World of Redemptions Through Related Corporations*, 22 TAX. L. REV. 161 (1967); *id.* at 721 addenda.

147. See *Commissioner v. Trustees Common Stock John Wanamaker*, 11 T.C. 365 (1948), *aff'd per curiam*, 178 F.2d 10 (3d Cir. 1949).

safe harbors under I.R.C. section 302(b). If the redemption does not fall within section 302(b), the earnings and profits of the parent, as increased by a deemed distribution to the parent by the subsidiary in the amount paid by the subsidiary for the stock, is the measure for dividend purposes.¹⁴⁸

Even stated in its simplest terms, I.R.C. section 304 is extremely convoluted and difficult to apply. Among the problems created by section 304 are the following: the earnings and profits allocation differs depending on whether parent-subsidiary or brother-sister corporations are involved; the calculation of control for determining brother-sister status requires application of the attribution rules in an expansive manner;¹⁴⁹ as a result of attribution, there is complete overlap of brother-sister and parent-subsidiary corporations so that whether section 304(a)(1) or section 304(a)(2) applies is uncertain;¹⁵⁰ the basis rules under the regulations are complicated by the deemed contribution to capital under I.R.C. section 304(a)(1).¹⁵¹

The origin of I.R.C. section 304 lies in the fact that a profitable sale of a capital asset will produce a capital gain even though a portion of the gain represents the value of reinvested earnings and profits. When those profits are paid out directly by the distributing corporation in a nonqualifying redemption, however, ordinary income treatment results. A "sale" of corporation stock to a related

148. See I.R.C. § 304(b)(2)(B). Whether the deemed distribution results in a constructive dividend or merely a constructive receipt by the parent of the subsidiary's earnings and profits is unresolved. Compare Rev. Rul. 69-261, 1969-1 C.B. 94 (constructive dividend) with *Webb v. Commissioner*, 67 T.C. 293 (1976), *aff'd per curiam*, 572 F.2d 135 (5th Cir. 1978) and *Virginia Materials Corp. v. Commissioner*, 67 T.C. 372 (1976) (no constructive dividend).

149. The ownership of at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes constitutes "control" under I.R.C. § 304(c)(1). The constructive ownership rule of I.R.C. § 304(c)(2) makes the 50% rule for corporation-shareholder attribution under I.R.C. § 318 inapplicable.

150. Treas. Reg. § 1.304-2(c) purports to distinguish between brother-sister and parent-subsidiary corporations and finds some support in the language of I.R.C. § 304. See *BIRRKER & EUSTICE*, *supra* note 32, at ¶ 9.31. Nevertheless, if A owns all the stock of X Corp. and Y Corp., under I.R.C. §§ 318(a)(3)(c) and 304(c)(2), X is deemed to be the parent of Y, and Y is deemed to be the parent of X.

151. For example, the "disappearing basis" rules of Treas. Reg. § 1.302(c) apply to I.R.C. § 304(a)(2) transactions under Treas. Reg. 1.304-3(a) but not to § 304(a)(1) transactions, because the shareholder is permitted to increase the basis of his stock in the acquiring corporation by the basis of the stock surrendered in accordance with Treas. Reg. § 1.304-2.

corporation vividly highlights the incongruity. Proposed section 300 does not address fully the I.R.C. section 304 problem. The proposal equates every sale of stock to a simultaneous redemption and purchase from the corporation. The seller will then recognize ordinary income to the extent of earnings and profits attributable to the stock transferred.¹⁵² Conceptually, when sole shareholder *A* sells his stock in *X* Corp. to a purchaser *P*, *A* is cashing out his investment in *X*, drawing out his pro rata share of earnings and profits, that is, his original investment and appreciation not due to reinvested earnings. At the same time *P* is, in effect, opening his *X* Corp. account with the purchase price. When *P* is a corporation closely related to *X* within the meaning of I.R.C. section 304, however, a problem arises in determining *A*'s pro rata share of earnings and profits. If the transfer is a sale, only *A*'s ratable share of earnings and profits *attributable to the stock transferred* will produce ordinary income. If the transfer is deemed a redemption because of the unity of *X* and *P*, the amount received will be ordinary income to the extent of *A*'s ratable share of earnings and profits without limitation.

Although proposed section 300 may lessen somewhat the need for I.R.C. section 304 because *A* in many cases will recognize some ordinary income, proposed section 300 leaves too much room for manipulation.¹⁵³ Some form of remedial provision is necessary. In theory, the provision would unite the issuing and acquiring corpo-

152. See Proposed §§ 300(6), (9), (10).

153. For example, consider the following illustrations involving *A*, *X* Corp., and *P* Corp.:

Example 1—*A* owns all of the stock of *X*, which is worth \$600 and has a basis of \$300. *X* has \$300 of earnings and profits. *P* Corp., owned solely by *X*, buys half the stock for \$300. If the transaction is treated as a sale, *A* would have \$150 ordinary income pursuant to proposed §§ 300(6) and (10), and \$150 basis return under proposed § 300(7). If treated as a redemption, all \$300 would be ordinary income as the pro rata redemption is ignored.

Example 2—Same as Example 1, except that *X* has \$0 and *P* has \$300 earnings and profits. Here, proposed § 300 would not help. Sales treatment would yield a \$150 capital gain because *X* has no earnings even though the appreciation is due to corporate earnings. Redemption treatment results solely in a \$300 return of basis, unless *P*'s earnings and profits serve as the measure.

Example 3—Same as Example 2, except *A* owns 100% of *X* and *P*. The analysis in Example 2 applies.

In each example, *A* has obtained \$300 of earnings and profits out of corporate solution without lessening control over *X* or *P*.

rations for purposes of determining whether a sale or pro rata redemption has occurred to the extent that the issuing corporation owns the acquiring corporation or vice versa, or the taxpayer owns both the acquiring and issuing corporation. For example, if Y, the acquiring corporation, were owned 50% by X, the issuing corporation, and 50% by other investors, and A, the sole shareholder of the issuing corporation, sold half his stock, the acquiring corporation would be united with the issuing corporation to the extent of the issuer's 50% ownership. Accordingly, one-half of the stock sold by A (25% of the outstanding stock) would be considered redeemed in a pro rata redemption that is treated as a distribution giving A ordinary income treatment to the extent of his ratable share of earnings and profits in X plus half of the earnings and profits of Y. The other half of the stock sold to Y would be treated as a sale producing ordinary income to A only to the extent of any remaining earnings and profits in X that are attributable to the stock sold in accordance with proposed section 300(10).¹⁵⁴ The proposed split treatment might require a *de minimus* rule when the overlap in ownership is relatively insignificant and does not suggest an attempted bail-out of earnings and profits.

C. I.R.C. Section 306

I.R.C. section 306, like section 304, was enacted to correct a weakness in the existing statutory treatment of dividends and redemptions. Sections 304 and 306 attempt to prevent a bail-out of

154. For example, A owns all of the stock of X Corp. (60 shares worth \$600 with a basis of \$300). X, with \$300 of earnings and profits, owns 50% of the stock of P Corp. which has \$0 earnings and profits. A sells 30 shares to P for \$300. Fifteen of the shares sold should be considered redeemed in a pro rata manner producing \$150 ordinary income in accordance with proposed § 300(6). (If X Corp. had \$0 earnings and profits and P Corp. had \$300 earnings and profits, the same result would follow, because P is considered merely an extension of X to the extent of X's 50% ownership. Accordingly, 50% of Y's earnings and profits would be used in the earnings and profits calculation). The other 15 shares sold will produce \$50 of ordinary income pursuant to proposed §§ 300(6) and (10):

<u>\$150 decrease in stock held.</u>	× \$150 earnings and profits remaining after the deemed
\$450 stock value	

pro rata redemption. The other \$100 received will reduce A's basis in accordance with proposed § 300(7). The result is a 33.33% decrease in A's stock ownership of X's \$300 basis.

The same analysis would apply in a brother-sister context if, for example, A owned 100% of X and 50% of P.

corporate earnings and profits at capital gains rates through a sale. The basic transaction is illustrated by *Chamberlin v. Commissioner*.¹⁵⁵ In *Chamberlin*, the taxpayer, an 83.8% owner of Metal Moulding Corporation, received a preferred stock dividend along with the other common shareholders. The preferred was 4.5% cumulative, \$100 par, and was subject to mandatory retirement over a seven-year period. Two days after the dividend distribution, negotiations initiated prior to the distribution culminated in an agreement by virtually all of Metal Moulding's shareholders to sell the newly-issued preferred to two insurance companies. The Sixth Circuit held that the pro rata distribution of preferred was not a taxable dividend and that no ordinary income was attributable to the taxpayer on the sale or the ensuing redemption. The result was that Metal Moulding distributed cash that went to the shareholders at capital gains rates even though no ultimate change in stock ownership occurred.¹⁵⁶

Congress attacked the preferred stock bail-out by enacting I.R.C. section 306 which originated "section 306 stock." In simple terms, the sale or other disposition of "section 306 stock" will produce ordinary income rather than capital gain. Section 306, however, is not simple in its application. Questions abound as to what constitutes "section 306 stock."¹⁵⁷ For example, the definition is limited to preferred stock; however, titular common stock with preferred characteristics has been classified as preferred stock for section 306 purposes.¹⁵⁸ Once "section 306 stock" is classified, its treatment

155. 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 374 U.S. 918 (1954).

156. In *Chamberlin v. Commissioner*, 18 T.C. 164 (1952), *rev'd*, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 374 U.S. 918 (1954) and *Estate of Rosenberg v. Commissioner*, 36 T.C. 716 (1961) (decided after the Sixth Circuit's reversal in *Chamberlin*), the Tax Court treated the attempted bail-out as though the corporation had distributed a cash dividend to the shareholders.

157. I.R.C. § 306(c)(1) applies to three categories of stock: § 306(c)(1)(A) addresses preferred stock received in a nontaxable distribution under § 305(a); § 306(c)(1)(B), relates to preferred stock received in certain reorganizations if the effect of the transaction is substantially the same as the receipt of a stock dividend, or if the stock received is in exchange for "section 306 stock"; § 306(c)(1)(C), controls stock the basis of which is determined by reference to the basis of "section 306 stock." See generally BITTKER & EUSTICE, *supra* note 32, at ¶ 10.03.

158. Rev. Rul. 57-132, 1957-1 C.B. 115. See Walter, 'Preferred Stock' and 'Common Stock': The Meaning of the Terms and the Importance of the Distinction for Tax Purposes, 5 J. CORP. TAX'N 211 (1978). In some situations, preferred stock with common charac-

varies depending on whether the stock is redeemed or sold.¹⁵⁹ Finally, the punitive treatment of "section 306 stock" does not apply to certain specified, but not always ascertainable, transactions deemed unsuitable for a bail-out of corporate earnings.¹⁶⁰

The evil that necessitates I.R.C. section 306 does not lie in the original dividend of preferred shares, nor in any sale, but rather in the redemption by the purchaser. Consider *X Corp.* with \$200 of earnings and profits, solely owned by *A* who holds common stock with a fair market value of \$1,000 and a basis of \$800. *X* declares a dividend of 10% preferred stock worth \$200. There are no immediate tax consequences on the pro rata distribution of *X's* stock.¹⁶¹ Under existing I.R.C. section 307, *A* allocates \$160 of basis to the preferred and \$640 to the common, which decreases in value to \$800 as a result of the distribution. Under a similar principle, \$40 of *X's* earnings and profits should be allocated to the preferred stock. If *A* sells the preferred to *I*, an insurance company, for \$200, I.R.C. section 306 and proposed section 300 yield different results. The existing provision immediately would tax *A* on \$200 of ordinary income.¹⁶² The result is difficult to defend because it is not the sale that gives rise to the bail-out. On the sale itself, *A* has given up some economic control over the corporation. After the sale, *A* holds common stock with a fair market value of \$800, and *I* holds \$200 of preferred. Arguably, there is no more reason under existing law to give *A* ordinary income treatment on the sale than if there had been no distribution and *A* merely sold \$200 of stock to *I*.

Proposed section 300 recognizes that the redemption, not the

teristics is not considered "section 306 stock." See Rev. Rul. 81-91, 1981-1 C.B. 123.

159. If stock is redeemed, § 306(a)(2) provides that the amount received is a § 301 distribution taxed as a dividend to the extent of the corporation's earnings and profits at the time of the redemption. If the stock is sold or otherwise disposed of, § 306(a)(1) bifurcates the amount realized. The amount that would have been a dividend if cash instead of stock originally had been distributed produces ordinary gain while the remainder is treated as sales proceeds.

160. See I.R.C. § 306(b). For example, see Rev. Rul. 75-247, 1975-1 C.B. 104 (sale of a portion of shareholder's common and § 306 preferred is not excepted automatically under I.R.C. § 306(b)(4); tax avoidance may not be a principal purpose).

161. See *Strassburger v. Commissioner*, 318 U.S. 604 (1943); proposed § 300(4) *supra* p. 13.

162. See I.R.C. § 306(a)(1). *A's* basis in the preferred would be transferred to the basis of the common. Treas. Reg. § 1.306-1(b)(2), Exs. 2, 3.

sale, provides the bail-out.¹⁶³ The sale should be treated as any other sale, with A recognizing as ordinary income his ratable share of X's earnings and profits attributable to the stock sold or \$40.¹⁶⁴ The remaining \$160 received by A will offset his \$160 basis in the preferred stock.¹⁶⁵ As long as I continues to hold the preferred, there is no justification for taxing A on the full \$200 value of the preferred stock. If I redeems the preferred for \$200, however, A will incur further tax consequences. Redemptions have two aspects under proposed section 300. First, there is a deemed pro rata distribution under proposed section 300(4). Second, there is a contribution to capital by the nonredeeming shareholders and a simultaneous redemption pursuant to proposed section 300(5). The \$200 distribution will be allocated on a pro rata basis by proposed section 300(4). Had there been merely a distribution of \$200, A's common stock would have decreased in value from \$800 to \$600.¹⁶⁶ However, because I's preferred stock is redeemed in exchange for the \$200 distribution, the value of A's common stock does not decrease by \$200 but remains at \$800 following the redemption. The \$200 "increase" in the value of A's stock, or alternatively the fact that A's stock did not decrease in value to \$600 following the distribution, determine that \$200 will be deemed distributed to A and \$0 to I under proposed section 300(4). Because A, following the transactions, becomes a 100% owner of X, the situation is as if \$200 were distributed to A who then purchased all of I's preferred stock. On the deemed distribution of \$200 to A, \$160 will be ordi-

163. In Rev. Rul. 81-91, 1981-1 C.B. 123, the IRS determined that participating, voting, preferred stock received in an E recapitalization was not "section 306 stock." The IRS identified stock subject to § 306 as follows:

The potential for a preferred stock bailout exists if the shareholders receive a pro rata distribution of two classes of stock in a recapitalization when the corporation has earnings and profits, and the stock of one class, because of its terms, can be disposed of without a surrender by the shareholders of significant interests in corporate growth.

Id. at 124. This formulation, however, fails to recognize that no corporate earnings have been bailed out by a sale. The earnings remain in corporate solution. Moreover, once the purchaser redeems the newly acquired stock, whether the stock would or would not share in future corporate growth is irrelevant.

164. See proposed §§ 300(6), (10) *supra* pp. 15-16, 19.

165. See proposed § 300(7) *supra* p. 16.

166. I's preferred stock would continue to be valued at \$200.

nary income.¹⁶⁷ The other \$40 will reduce A's basis in his common stock from \$640 to \$600.¹⁶⁸ The second aspect of the redemption is a deemed contribution to capital by A of \$200, increasing A's basis to \$800, followed by a redemption of I's stock with a \$200 cost basis, producing no further gain.

In sum, A would recognize \$40 of ordinary income on the sale and an additional \$160 of ordinary income on any subsequent redemption. A would accumulate 100% of the outstanding stock of X with a fair market value and basis of \$800.¹⁶⁹ Because proposed section 300 prevents bail-outs without special classification of stock, it would eliminate the definitional and operational problems that presently plague I.R.C. section 306 and more accurately reflect the economic realities of a sale by a shareholder of "section 306 stock." Although proposed section 300 cuts back the overreach of

167. After recognizing \$40 of ordinary income on the sale to I, A's ratable share of earnings and profits decreases from \$200 to \$160 which is recognized by proposed § 300(6) on the deemed distribution.

168. See proposed § 300(7) *supra* p. 16.

169. Differences between I.R.C. § 306 and proposed § 300 also are apparent when "section 306 stock" is redeemed instead of sold. If the common stock of X Corp. in the textual example is held evenly by A and B, each has stock with a fair market value of \$500 and a basis of \$400. When X distributes a \$100 preferred stock dividend to A and B, no tax consequences result from the pro rata distribution, and each shareholder's common stock decreases in value to \$400. The preferred is "section 306 stock" under existing I.R.C. § 306(c)(1)(A). If X redeems A's preferred stock in a non-pro rata redemption, I.R.C. § 306(a)(2) would tax him on \$100 ordinary income, even though by redeeming, A has decreased his ownership of X (A now holds stock valued at \$400 and B holds stock worth \$500).

Proposed § 300 respects the change in percentage of ownership while recognizing some of X's distribution constitutes ordinary income. Proposed § 300(4) treats the \$100 distribution on a pro rata basis, giving A and B each \$50 of ordinary income pursuant to proposed § 300(6). Proposed § 300(5) then gives B a constructive contribution to capital of \$50, raising his basis by that amount. Simultaneously, A redeems his preferred for \$50. A's ownership after the redemption is decreased by 11.11%. Immediately after the deemed distribution and prior to the redemption, A owned \$450 of stock (\$100 preferred and \$350 common). After the redemption, A owned only \$400 of common stock. The percentage decrease in his ownership is \$450.

The preferred and common, although separate classes of stock, are considered jointly because the basis, earnings, and profits attributable to the preferred were derived from the common. Accordingly, 11.11% of A's ratable share of remaining earnings and profits (\$50), and A's stock basis (\$400), are allocable to the stock redeemed. See proposed §§ 300(8), (10) *supra* at 17, 19. A has \$5.56 ordinary income on the redemption, and the remaining \$44.44 received reduces the basis attributable to the redeemed stock to \$0. A is left with a basis of \$355.56 in his common stock. In sum, A recognizes \$55.56 and B recognizes \$50 of ordinary income, reflecting the fact that A has pulled cash out of X only by weakening his percentage of ownership.

I.R.C. section 306 on sales and redemptions of "section 306 stock," proposed section 300 would extend the logic behind I.R.C. section 306 to transactions that might not be covered by that provision.¹⁷⁰ For example, if A, the sole shareholder of X Corp., sells 10% of his common stock to I, who has its stock redeemed, under existing law A effectively has received a distribution from X at a capital gains rate.¹⁷¹ Proposed section 300, however, assures that A will recognize ordinary income on the sale and on the redemption regardless of whether common or preferred stock serves as the bail-out vehicle.¹⁷²

D. *Bootstrap Acquisitions*

A shareholder in a closely held corporation who desires to sell his stock interest may confront a purchaser who is unable or unwilling to pay the agreed upon fair market value of the stock interest. Often, a transaction can be structured in which cash in the corporation to be acquired can be distributed to the seller, thereby reducing the purchaser's cost by the amount of the acquired corporation's own funds. This bootstrap acquisition can be accomplished through either a pre-sale dividend to the seller or a partial redemption of the seller's stock in conjunction with a sale to the purchaser.¹⁷³ Although the techniques may differ, the economic results

170. For a discussion of common stock bail-outs, see Gallagher, *Common Stock Bailouts: A Planning Device for the Close Corporation*, 11 TAX ADVISER 106 (1980); Lowe, *Bailouts: Their Role in Corporate Planning*, 30 TAX L. REV. 357, 411-17 (1975).

171. For an indication of the bail-out potential of common stock, see BRUDNEY & CHIRELSTEIN, *CORPORATE FINANCE* 461-70 (1979).

172. Under current law, a variety of bail-out mechanisms remain. In *Palmer v. Commissioner*, 62 T.C. 684 (1974), *aff'd on other grounds*, 523 F.2d 1308 (8th Cir. 1975), the taxpayer donated stock in a corporation to a foundation, both of which he owned. The day after the donation, the corporation agreed to redeem the foundation's stock. The Tax Court held that the transaction constituted a valid gift to the foundation followed by a redemption, rather than a nonqualifying redemption by the shareholder that would produce ordinary income followed by a gift to the foundation. In Rev. Rul. 78-197, 1978-1 C.B. 83, the IRS approved the *Palmer* result so long as the donee is not obligated to redeem at the time the donee receives the gift. Although proposed § 300 would not tax the donor on the initial gift, the subsequent redemption would be treated as a pro rata distribution to the donor in accordance with proposed § 300(4), followed by a deemed contribution to capital, thereby limiting the effectiveness of the bailout.

173. For a general discussion of the bootstrap problem, see Jassy, *The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route Vs. The Dividend Route*, 87 HARV. L. REV. 1459 (1974); Kingson, *The Deep Structure of Taxation: Dividend Distributions*, 85

as indicated in part I of the Article are identical.¹⁷⁴ In the area of bootstrap acquisitions, however, the present law seriously stumbles as it awkwardly grasps for a logical principle.¹⁷⁵ Provided with only "the now concretized standard of form over substance," courts predictably have struggled to produce consistent results.¹⁷⁶

Considering the redemption line of cases first, precedent directs that a redemption of a portion of a seller's stock in conjunction with a sale, which together satisfy the requirements of I.R.C. section 302(b), will enjoy capital gains treatment.¹⁷⁷ Whether the redemption of the selling shareholder's stock will be treated as a dividend to the purchaser will depend on whether the purchaser is relieved of a personal contractual obligation to purchase the redeemed stock.¹⁷⁸ Yet, regardless of whether the purchaser is obli-

YALE L.J. 861 (1976).

174. Cases 1 to 5 *supra* pp. 3-4 illustrate the economic equivalence of a variety of bootstrap acquisitions in which the purchaser, an existing 50% shareholder, seeks to end up with 75% ownership of a corporation at no direct cost. In each case, the shift in ownership is financed by a \$1,200 distribution from the acquired corporation. As indicated, existing law yields a variety of inconsistent tax results. Proposed § 300, however, would recognize the economic equivalence of each variation. *See supra* pp. 19-26.

175. Judge Tannenwald reveals his frustration and despair in this area in a recent case: Once again, we face the issue of whether the redemption of one shareholder by a corporation constitutes a constructive dividend to the remaining shareholders. No useful purpose would be served by an extensive discussion of the numerous cases which have dealt with this issue, because each case turns on its own facts and circumstances.

Daniel T. Jacobs, 1981 T.C.M. (P-H) ¶ 81,081.

176. *Id.*

177. *See Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) (redemption met requirements of I.R.C. § 302(b)(3)); Rev. Rul. 55-745, 1955-2 C.B. 223 (IRS will follow *Zenz*). For a discussion of *Zenz* as applied to I.R.C. § 302(b)(2) redemptions, see *Ted Bates & Co.*, 1965 T.C.M. (P-H) ¶ 65,251; Rev. Rul. 75-447, 1975-2 C.B. 113. If the sale and redemption are not made pursuant to a sufficiently definite plan, *Zenz* does not apply. *See, e.g., Benjamin v. Commissioner*, 66 T.C. 1084 (1976), *aff'd*, 592 F.2d 1259 (5th Cir. 1979); *Niedermeyer v. Commissioner*, 62 T.C. 280 (1974), *aff'd per curiam*, 535 F.2d 500 (9th Cir.), *cert. denied*, 429 U.S. 1000 (1976).

178. *Compare Wall v. United States*, 164 F.2d 462 (4th Cir. 1947) (purchaser taxed when the acquired corporation discharged the purchaser's purchase money obligation acquired after the sale but prior to payment) with *Edenfield v. Commissioner*, 19 T.C. 13 (1952) and Rev. Rul. 69-608, 1969-2 C.B. 42 (no dividend to purchaser where no personal obligation existed to purchase shares redeemed).

In *Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958), the court held that assignment by the purchaser to the corporation of an option to purchase the seller's shares fell on the *Edenfield* end of the spectrum. In following *Holsey*, the IRS endeavored to de-emphasize the form of the transaction, focusing on the date, if any, when a purchaser is under a pri-

gated to purchase shares, a redemption by the corporation will have the same economic consequences.¹⁷⁹ The focus on the source of the obligation to purchase is misplaced.

The same exaggerated emphasis on motive and obligation is more apparent in the dividend line of cases. In *Steel Improvement and Forge Co. v. Commissioner*,¹⁸⁰ after a stock purchase contract had been executed, a dividend was paid to the seller as contemplated by the contract. The price paid by the purchaser was not reduced by the amount of the dividend. The Tax Court found a dividend to the seller because the purchaser never was obligated to pay a higher purchase price.¹⁸¹ The Sixth Circuit reversed, determining that beneficial ownership had passed to the purchaser prior to declaration of the dividend. The dividend was taxed to the purchaser and treated as part of the sales proceeds received by the seller.

The Tax Court relied upon the Sixth Circuit's opinion in *Steel Improvement and Forge* when *Waterman Steamship Corp. v. Commissioner*¹⁸² was argued. In *Waterman Steamship*, a corporation distributed a promissory note to the seller prior to the signing of a binding purchase contract.¹⁸³ Immediately subsequent to the dividend, the purchaser acquired the seller's stock while providing funds to the acquired corporation to discharge the promissory note. Because there was no shift in beneficial interest when the dividend was declared and paid, the Tax Court held that the seller was taxable. The Fifth Circuit reversed, treating the distribution as part of the sales proceeds, in part, because the purchaser's funds were used to pay the dividend.¹⁸⁴

By the time *Casner v. Commissioner*¹⁸⁵ was decided, the Tax Court thought it understood the circuit court's mandate. The taxpayer in *Casner* sought to transfer all his stock in two corporations

mary and unconditional obligation to purchase. See Rev. Rul. 58-614, 1958-2 C.B. 920; Rev. Rul. 69-608, 1969-2 C.B. 42.

179. See BITTKER & EUSTICE, *supra* note 32, at ¶ 9.25.

180. 314 F.2d 96 (6th Cir. 1963).

181. 36 T.C. 265 (1961).

182. 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970).

183. The seller, a corporation, preferred a dividend accompanied by a reduced purchase price in order to take advantage of the I.R.C. § 243 deduction. 430 F.2d at 1187.

184. The Fifth Circuit ruled that there was no dividend to either party. *Id.* at 1191-92.

185. 450 F.2d 379 (5th Cir. 1971).

to existing shareholders and to third parties. Prior to the execution of any purchase contract, the corporations paid out pro rata dividends to the extent of the corporations' paid-in capital surplus.¹⁸⁶ The IRS, contrary to its position in *Waterman Steamship*, argued that the payment was a dividend to the seller.¹⁸⁷ Applying precedent to the facts in *Casner*, the Tax Court observed the following: the purchasers never were bound to pay an additional amount equal to the dividends paid; the dividends were declared and paid prior to any binding contract; shareholders who were not involved with the sale or purchase of the stock received dividends; in contrast to *Waterman Steamship*, cash was distributed; and beneficial ownership, as defined in *Steel Improvement and Forge*, had not passed to the purchasers.¹⁸⁸ Consequently, the Tax Court concluded that the sellers and other shareholders receiving distributions should be taxed on the dividends.¹⁸⁹ Again, the Tax Court was reversed. The Fifth Circuit, relying heavily on both *Steel Improvement and Forge* and *Waterman Steamship* held that the distributions were taxable to the purchasers as constructive dividends and then taxable to the seller as sales proceeds. While criticizing the IRS for taking inconsistent positions in *Waterman Steamship* and *Casner*, the court relied on the parties' intention to accomplish the sale through an integrated plan as well as the "economic substance" of the transaction.¹⁹⁰

Commentators and courts have struggled to find reason where little exists. One suggestion is to conform the dividend line of cases

186. An understanding existed that the stock would be purchased shortly after the dividend distribution at book value adjusted for the declared dividends.

187. Neither the buyers nor the sellers reported dividend income. The sellers viewed the distribution as part of the purchase price, and the buyers claimed the distributions (even those received directly by them) were income to the sellers.

188. See Jassy, *supra* note 173, at 1473.

189. 28 T.C.M. (CCH) 535, 541 (1969).

190. 450 F.2d at 398. *But see* Rev. Rul. 75-493 1975-2 C.B. 109 (the IRS will not follow *Casner*).

Most recently in *TSN Liquidating Corp. v. United States*, 624 F.2d 1328 (5th Cir. 1980), the Fifth Circuit reversed the district court in a bootstrap transaction. A dividend in kind of unwanted portfolio assets, followed by a sale of stock by the controlling corporate shareholder to a new buyer who promptly infused the acquired corporation with cash and portfolio assets, was ruled a dividend to the seller by the Fifth Circuit. The insertion of assets into the acquired corporation by the purchaser was not, alone, sufficient to invoke the *Waterman Steamship* precedent. 624 F.2d at 1334.

to the redemption line of cases so that any corporate distribution to the seller that does not relieve a purchaser's obligation could be treated as a redemption if the standards of I.R.C. section 302(b) are met.¹⁹¹ Other commentators have suggested that because a dividend has no economic substance, certainty and predictability of result can be achieved only by focusing on the negotiation and the form of the transaction.¹⁹²

Proposed section 300 eliminates the bootstrap problem by giving all economically identical transactions identical tax results. Proposed section 300 accomplishes this consistency by focusing on the outcome of the transaction regardless of motive, satisfaction of an obligation, or distributions by redemption or dividend. The order of transactions is irrelevant if they conclude identically. To illustrate, assume *X Corp.*, with \$300 of earnings and profits, is solely owned by *S* whose ten shares have a fair market value of \$1,000 and a basis of \$700. *P* desires to purchase all of the stock of *X*, but has only \$700. The options include the following:

- Option 1—Payment of a \$300 dividend to *S* followed by a sale to *P* of all ten shares for \$700, the reduced value of the stock.
- Option 2—Purchase of all ten shares for \$1,000 followed by a dividend to *P* of \$300.
- Option 3—Redemption of three shares of stock for \$300 followed or preceded by a sale of the remaining seven shares to *P* for \$700.

Under all three options, *S* will be taxed on \$300 of ordinary income. All of the appreciation in his stock is due to *X*'s earnings and profits. Whether he received those earnings and profits in the form of a dividend, increased sales price, or redemption, the earnings and profits would not be transformed into capital gains under proposed section 300. The result in Option 1, mandated by proposed section 300(4), does not hinge on whether beneficial owner-

191. See Jassey, *supra* note 173, at 1479-82. This approach has been criticized for jeopardizing tax-free reorganization treatment under I.R.C. § 368(a)(1)(B) when a dividend is declared immediately prior to stock-for-stock acquisition. See Kingson, *supra* note 173, at 867 n.30.

192. See Kingson, *supra* note 173. See also Ginsburg, *Letter*, 86 YALE L.J. 798, 804 (1977) (criticizing part of Kingson's conclusion and suggesting that bootstrap distributions be treated not as payments in redemption, nor as dividends, but as capital payments).

ship had passed to the purchaser,¹⁹³ on the intention of the parties,¹⁹⁴ or on whether the actual proceeds of the distribution were provided by the purchaser.¹⁹⁵ As Option 2 illustrates, even when the dividend is paid directly to *P*, *S* still must account for the distribution of earnings and profits he receives through an enriched sales price.¹⁹⁶ Option 3, which may produce capital gains under *Zenz v. Quinlivan*,¹⁹⁷ is treated identically to Options 1 and 2. Even if *P* had obligated himself personally to purchase all of *S*'s stock before shifting part of the obligation to *X*, *P* would receive no dividend income under the proposal.¹⁹⁸

Proposed section 300 offers the promise of predictability and logic in an area where uncertainty has caused extensive litigation. Not only has there been a significant number of litigated cases, but the focus of the litigation often has been divorced from the substance of the transaction—that is, the amount and nature of the income received by the seller.¹⁹⁹

E. Liquidations

The theory behind proposed section 300, that earnings and profits be taxed at ordinary rates whenever extracted from corporate form, should apply to liquidations as well as to operating distribu-

193. See *Steel Improvement and Forge Co. v. Commissioner*, 314 F.2d 96 (6th Cir. 1963).

194. See *Casner v. Commissioner*, 450 F.2d 379 (5th Cir. 1971).

195. See *Waterman Steamship Corp. v. Commissioner*, 430 F.2d 1185 (5th Cir. 1970). If *X* had distributed a note to *A* because earnings and profits had been reinvested, no change should result. The fact that the cash to discharge the note eventually was provided by *P* also would be irrelevant. Regardless of the physical source of the funds, \$300 of what *S* receives represents the earnings and profits of *X* Corp.

196. Proposed § 300(5) treats the transaction as if *S* closes his corporate account and receives his original \$700 of capital in addition to \$300 of taxable earnings and profits. Simultaneously, *P* opens his corporate account with the \$1,000 purchase price. Because *S* is taxed on the sale to the extent of *X*'s earnings and profits, the distribution to *P* will be a return of capital under proposed § 300(7), thus reducing *P*'s basis to \$700.

197. 213 F.2d 914 (6th Cir. 1954).

198. Proposed § 300 rejects the judicial reasoning in the line of cases and rulings typified by *Holsey v. Commissioner*, 258 F.2d 865 (3d Cir. 1958) and Rev. Rul. 69-608, 1969-2 C.B. 42, under which obligation rather than economics determines the outcome.

199. See, e.g., *Daniel T. Jacobs*, 1981 T.C.M. (P-H) ¶ 81,081; *Sullivan v. United States*, 363 F.2d 724 (8th Cir. 1966), cert. denied, 398 U.S. 905 (1967); *Wolf v. Commissioner*, 357 F.2d 483 (9th Cir. 1966). These cases illustrate the preoccupation with determining whose obligation is discharged by the redeeming corporation.

tions.²⁰⁰ Existing I.R.C. sections 331(a)(1) and (2), however, provide for exchange treatment for qualifying liquidations even though a portion of the distribution may be comprised of corporate earnings and profits. Predictably, taxpayers flushed with the excitement of turning ordinary income into capital gains have pushed both the partial and complete liquidation provisions beyond their limits.

I.R.C. section 346(a)(2) provides that a distribution in redemption be treated as a partial liquidation if it is "not essentially equivalent to a dividend." This category of partial liquidations focuses on "what happens solely at the corporate level by reason of the assets distributed" or the concept of "corporate contraction."²⁰¹ This formulation is fundamentally problematic. The "corporate contraction" standard is hopelessly imprecise. Every pro rata distribution of earnings and profits contracts the corporation.²⁰² Moreover, the emphasis on corporate motive in determining the character of a distribution is inconsistent with basic tax concepts. For instance, in a simple distribution situation, the fact that a corporation intends to return the taxpayer's original capital is irrelevant if there are earnings and profits.²⁰³ The Code does not trace; earnings and profits come out first. Similarly, the fact that a corporation attempts to trace the distribution of funds to capital invested in a terminated business should be irrelevant if the distributing corporation has earnings and profits.

Revised Ruling 76-289²⁰⁴ illustrates the tracing problem. There, the IRS ruled that a profitable wholesale appliance distributorship could distribute the working capital of its terminated retail division in partial liquidation under I.R.C. section 346(a)(2). Capital

200. Proposed §§ 300(1) and (3) are intended to cover both partial and complete liquidations that are, in effect, no more than partial or complete redemptions of the stock of all the shareholders.

201. S. REP. NO. 1622, 83d Cong., 2d Sess., 49, reprinted in 1954 U.S. CODE CONG. & AD. NEWS 4621, 4680.

202. For criticism of the "corporate contraction" doctrine, see Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 472-73 (1950); Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1, 5-13 (1958).

203. See I.R.C. § 301(c)(1).

204. Rev. Rul. 76-289, 1976-2 C.B. 100.

gains treatment results even though the ruling states explicitly that "the additional funds invested in the retail division were derived from the profitable operations of the wholesale division." Noting that whether earnings and profits become working capital depends on the facts and circumstances of each case, the IRS found the "gradual commitment of the funds" dispositive.²⁰⁵ Presumably, if earnings and profits had been transferred to the retail division immediately prior to the corporate transaction, dividend treatment would have resulted. Rather than tracing the distributed funds, proposed section 300 would look to the corporate distributor only to determine the amount of earnings and profits. The distribution would then be evaluated at the shareholder level in accordance with the order of receipt for all distributions: first, the allocable earnings and profits; second, return of basis; third, capital gain.²⁰⁶

The stress point in the area of complete liquidations is the liquidation-reincorporation phenomenon by which taxpayers who never intend to leave the corporate form liquidate and reform solely for tax reasons.²⁰⁷ In its simplest form, the pattern is as follows: *X Corp.*, with original assets of \$1,000 and cash from earnings and profits of \$1,000,000, liquidates. *A*, the sole shareholder holding stock with a \$1,000 basis, reports a \$1,000,000 capital gain.²⁰⁸ The next day, *A* contributes his original \$1,000 to the *New X*. If successful, *A* has pulled out earnings and profits at a capital gains rate. The liquidation-reincorporation pattern also can be used to obtain a stepped-up basis for inventory or depreciable assets at a capital gains rate.²⁰⁹

205. *Id.* at 101.

206. See proposed §§ 300(6), (7) *supra* pp. 15-16.

207. See generally BITTKER & EUSTICE, *supra* note 32, at ¶¶ 11.05, 14.54.

208. See I.R.C. § 331. *X* has no gain on the liquidation under I.R.C. § 336. *A* has no further gain on reincorporation if the transfer qualifies under I.R.C. § 351. An alternative method of reaching the same result is for the liquidating corporation to transfer its operating assets to a new corporation controlled by the same shareholders, for cash or other property, followed by a liquidation.

209. I.R.C. § 334(a) gives shareholders a fair market basis on a liquidation. Although I.R.C. §§ 47(a)(1), 1245, and 1250 override § 336, a low corporate tax rate may inspire a liquidation-reincorporation involving depreciable property when the corporation expects to be in a higher bracket in the future. Also, because I.R.C. § 1250 does not recapture straight-line depreciation, liquidation-reincorporation can renew basis at no cost of recapture. Recapture aside, any appreciation in depreciable property can be extracted at capital gains

With admirable persistence, the IRS has fought to reclassify the liquidation-reincorporation device as a reorganization in which taxable boot is distributed,²¹⁰ or to treat the transactions as a "sham" giving rise to dividend treatment under I.R.C. section 301.²¹¹ In spite of the IRS's efforts, reclassification has not always been possible, even when appropriate. For instance, failure to prove either sufficient continuity of shareholders' proprietary interest in both the liquidating and new corporation or continuity-of-business enterprise will defeat reorganization treatment.²¹²

In *Commissioner v. Berghash*,²¹³ Berghash, who owned virtually 100% of Delavan-Bailey, the liquidating corporation, decided to transfer 50% control to Lettman, an irreplaceable employee.²¹⁴ Delavan-Bailey held operating assets valued at \$121,000. Lettman, however, had only \$25,000. To achieve their goal, Berghash and Lettman entered into an agreement providing a sale of Delavan-Bailey's operating assets to a new corporation, Dorn's, in exchange for 100 shares of Dorn's common stock valued at \$25,000 and a promissory note for \$96,101.64. At the same time, Lettman purchased 100 shares of Dorn's common stock for \$25,000. Following the sale, Delavan-Bailey liquidated, distributing to Berghash the 100 shares of Dorn's stock, the promissory note, and \$49,313.17 in cash. Berghash reported a capital gain of \$168,203.35.²¹⁵ Delavan-Bailey, relying on I.R.C. section 337, reported no gain.²¹⁶

In filing its notice of deficiency, the IRS argued that the distri-

rates and give the shareholder a stepped-up basis.

210. When the liquidating corporation transfers assets to the new corporation through shareholder-conduits, reclassification as a reorganization governed by I.R.C. § 368(a) and related provisions, embodies the spirit of *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). For a discussion of reclassification as D reorganization, see, e.g., *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966); *James Armour v. Commissioner*, 43 T.C. 295 (1964).

211. See *Bazley v. Commissioner*, 331 U.S. 737 (1947); *Gregory v. Helvering*, 293 U.S. 465 (1935); *Treas. Reg. §§ 1.301-1(1), 1.331-1(c)*; *Rev. Rul. 61-156*, 1961-2 C.B. 62.

212. Similarly, the IRS's attempts to treat liquidation-reincorporations as "shams" or as dividends severable from reorganizations have met with limited success. See *BITTKER & EUSTICE*, *supra* note 32, at ¶ 11.05 n.41.

213. 361 F.2d 257 (2d Cir. 1966).

214. Berghash owned 99% and his wife owned 1% of the outstanding stock. 361 F.2d at 258-59.

215. The fair market value of the distribution was \$170,414.81, and Berghash had a \$2,211.46 stock basis. *Id.* at 259.

216. The unrecognized gain on the sale was \$46,218.24. *Id.*

bution received by Berghash was in the nature of a dividend to the extent of Delavan-Bailey's \$122,050.11 of earnings and profits because the transaction lacked economic substance or, alternatively, constituted a D or F reorganization. Both the Tax Court and the Second Circuit determined that the transfer was founded upon a bona fide business purpose, the retention of a valuable employee. Moreover, because Berghash, a 100% owner of Delavan-Bailey, was only a 50% owner of Dorn's, there was insufficient continuity of shareholder interest to justify reorganization treatment.²¹⁷ The result was a bail-out of earnings and profits at a capital gain rate.

The result in *Berghash* is another victory of form over substance. The economic result is identical to the direct distribution of a \$96,101.64 promissory note and \$49,313.17 in cash which would reduce the value of Delavan-Bailey to \$25,000. If Lettman then purchases \$25,000 of new stock, he and Berghash would be 50% owners. Under this formulation, Berghash clearly would have ordinary income on the distribution to the extent of earnings and profits. The percentage of stock purchased by Lettman is irrelevant in determining the tax consequences to Berghash on the distribution; yet, the percentage of stock purchased was the basis of the decision in *Berghash*.²¹⁸ Simply stated, Delavan-Bailey earned \$122,050.11 and distributed that amount and more. Whether the distribution was nominally part of a reorganization, part of a sale and liquidation, or simply a distribution accompanied by a stock purchase should have no special tax consequences when the end result is identical.

Proposed section 300(6) guarantees ordinary income treatment, regardless of the form, to the extent of the distributing corpora-

217. 43 T.C. 743, 754 (1965).

218. Interestingly, the Tax Court rejected application of the attribution rules of I.R.C. § 318 even though Berghash had an option to purchase Lettman's stock in Dorn's. 43 T.C. at 757.

For an example of the Code's misdirected concern with continuity at the corporate level, see *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965). In *Pridemark*, the court focused on the one-year period between liquidation and reincorporation and concluded that reincorporation treatment was inappropriate. As a result, I.R.C. § 331 gave the shareholder capital gains treatment in spite of ample earnings and profits. To the extent that earnings and profits passed out of corporate solution to the shareholder, ordinary income should have resulted regardless of characterizations of the earnings and profits as liquidation or reorganization distribution.

tion's earnings and profits. This change would curtail the liquidation-reincorporation device as a means of pulling out ordinary income at capital gains and eliminate the corporate earnings and profits account. Some other liquidation-reincorporation advantages, however, would remain. Proposed section 300 does not address the use of reincorporation to obtain a stepped-up basis when reorganization analysis would carry over the original basis. Nor does proposed section 300 address the availability of I.R.C. section 337, which can eliminate a corporate tax when liquidation is involved, but is not available if a sale is made pursuant to a reorganization. For corporations with earnings and profits, however, attempted reincorporations to take advantage of basis adjustments would be accomplished at an ordinary income cost, effectively curbing the appeal of converting ordinary income to capital gains.

A problem related to the reincorporation device is the collapsible corporation, currently addressed by I.R.C. section 341.²¹⁹ To illustrate, Builder with \$10,000 forms X Corp. which constructs (using borrowed funds), but does not sell, houses with a fair market value of \$1,000,000. In the absence of a remedial provision, Builder liquidates, recognizing a \$990,000 capital gain and receiving a \$1,000,000 stepped-up basis. Builder then can sell the ordinary income property without recognizing further gain or, if the continuity-of-business problems are surmounted, reincorporate and have the new corporation execute the sales. Either method allows Builder to pull out potential ordinary income at capital gains rates in order to step up basis.

Congressional response to collapsible corporations came in the form of I.R.C. section 341, a temple to obfuscation, the clarity of which is typified by the more than 300 word first sentence of I.R.C. section 341(e). The progenitors of I.R.C. section 341 have been identified as the capital gains preference and the *General Utilities*²²⁰ rule that permit corporations to distribute appreciated property free of corporate income tax and with a stepped-up basis.²²¹ The reform efforts aimed at simplifying I.R.C. section 341

219. For a complete discussion of the area, see Ginsburg, *Collapsible Corporations—Revisiting an Old Misfortune*, 33 TAX L. REV. 309 (1978).

220. *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935).

221. See Ginsburg, *supra* note 212, at 325. The rule from *General Utilities* is embodied in I.R.C. §§ 311 and 336 which operate along with §§ 337 and 334(b)(2) to provide a step-up in

have focused on the more palatable disposition of the *General Utilities* rule as opposed to the capital gains privilege.²²²

Proposed section 300 would not require the complete undermining of the *General Utilities* principle, in part, because the proposal cuts back on the definition of capital gains. Instead, to mitigate the problem, proposed section 300 requires an expansion of I.R.C. section 312(b) creating a corporate earnings and profits account equal to the value of any stock of appreciated inventory distributed in a redemption or liquidation. Once an earnings and profits account is created, Builder, in the example above, will have ordinary income on the distribution under proposed section 300(6).

To nullify completely the collapsible corporation incentive, any expansion or adaptation of the section 312(b) principle also must apply to stock sales.²²³ In the example above, Builder might just as conveniently have sold his stock to a third party, reporting a \$990,000 capital gain in the absence of a remedial provision.²²⁴ Because Builder's stock is only worth \$1,000,000 due to appreciated inventory in corporate solution, he should report the appreciation as ordinary income on the sale of his stock. To accomplish this, appreciated inventory must be considered to increase the earnings and profits of a corporation for purposes of any stock sale.²²⁵ Moreover, if Builder's corporation does not own appreciated inventory directly, but rather is a shell corporation owning stock in a corporation holding only appreciated inventory, earnings and profits must be increased to the extent that appreciated stock owned by the shell is due to appreciated inventory.²²⁶ If Builder liquidates

basis at no corporate tax cost.

222. See HOUSE COMM. ON WAYS AND MEANS, 86th Cong., 1st Sess., (Lewis) *A Proposed New Treatment for Corporate Distributions and Sales in Liquidations*, 3 TAX REVISION COMPENDIUM 1643 (Comm. Print 1959); FEDERAL INCOME TAX PROJECT ON SUBCHAPTER C—CORPORATE ACQUISITIONS (Tent. Draft No. 1, 1977).

223. I.R.C. § 312(b), which applies only to distributions, is a compromise provision. Section 312(b) does not tax a distributing corporation on appreciated inventory, but § 312(b) insures that earnings and profits will be sufficient to provide an individual shareholder with ordinary income at least equal to the appreciation before obtaining a fair market value basis under I.R.C. § 301(d).

224. If the purchaser liquidated, there would be no gain, and the purchaser, if an individual, would have a stepped-up basis under I.R.C. § 334(a).

225. Proposed §§ 300(5) and (6) will then treat any sales proceeds as ordinary income to the extent of the earnings and profits.

226. Similarly, if A owns X Corp. which holds appreciated stock in Y Corp. which has

the shell or sells his stock in the shell corporation, ordinary income will result to the extent of the enriched earnings and profits account.

Tracing the earnings and profits attributable to each stock holding of a corporation presents a formidable administrative task. This task is particularly burdensome in the case of a corporate chain, for example, where X Corp. owns shares in Y Corp. which owns shares in Z Corp. and so forth. Application of a *de minimus* rule here still could sour the appeal of collapsible corporations without being unworkable. I.R.C. section 341(d)(2) presently protects a shareholder from collapsible treatment if 70% or less of the gain on a liquidation, sale, or distribution is traceable to collapsible property.²²⁷ The 70% measure is generous in permitting collapsibility. Many of the potential administrative problems probably could be avoided if 25% or 30% were used as a measure. A workable *de minimus* rule might be structured around the following guidelines: if 30% or more of the fair market value of a corporation is a result of property that would produce ordinary income if sold, earnings and profits of the corporation shall include any net appreciation in such property.²²⁸

F. *Accumulated Earnings and Undistributed Income*

Whether adoption of the proposed section 300 framework would have any effect on corporations improperly accumulating income or on those functioning as personal holding companies is conjectural. The accumulated earnings and the personal holding company tax provisions address the misuse of a corporate form to shield income from individual tax rates that exceed corporate rates.²²⁹ To remove the earnings from corporate solution, a share-

turned the appreciated inventory into earnings and profits, a sale of the X Corp. stock or a liquidation of X should be evaluated by taking into account the earnings and profits inherent in the appreciated Y Corp. stock.

227. Treas. Reg. § 1.341-4(c)(2) measures the gain attributable to the collapsible property by determining the difference between the gain recognized by the shareholder and the gain that would have been recognized if the collapsible property had not been purchased or produced.

228. In conjunction with proposed § 300, this framework would cover the ownership by a corporation of stock in another corporation either with existing earnings and profits or with appreciated inventory. See *supra* note 226.

229. For a discussion of the accumulated earnings tax, see Cunningham, *More Than You*

holder may attempt to sell stock, transfer it to his heirs at death, or exchange it for publicly held stock in a reorganization. Proposed section 300 would cause a shareholder to report ordinary income on any stock sale to the extent of earnings and profits, and would produce ordinary income on a sale of stock by a shareholder's heirs.²³⁰ Because proposed section 300 curtails the opportunities to transform corporate earnings into capital gains, the accumulated earnings and personal holding tax provisions no longer may be needed. Even if a taxpayer could not escape eventual ordinary income treatment to himself or to his heirs, however, deferral of taxes or the hope for a change in the law still might spur the type of corporate accumulations that I.R.C. sections 531 and 541 were meant to address.

Assuming that the accumulated earnings tax remains in place, proposed section 300 still would have a salutary effect. Under existing law it is possible for the IRS successfully to impose the accumulated earnings tax on a corporation with no earnings for the year or years in question.²³¹ For example, X Corp. formed in 1960 accumulates \$1,000,000 of earnings and profits by December 31, 1969. There are no further accumulations during the 1970's or in 1980. In 1981 X earns \$500,000, but distributes all of the earnings in a redemption qualifying for capital gains treatment under I.R.C. section 302.²³² I.R.C. section 532(a) applies the accumulated earnings tax to a corporation formed or availed of for the purpose of avoiding income taxes "by permitting earnings and profits to accu-

Ever Wanted to Know About the Accumulated Earnings Tax, 6 J. CORP. TAX'N 187 (1979); Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 MICH. L. REV. 421 (1965).

230. Even though I.R.C. § 1014 provides a step-up in basis at death, it has no effect on the corporate earnings and profits account. On any sale by an heir, proposed § 300 would produce ordinary income to the extent of the allocable portion of earnings and profits. There may also be a capital loss because the heir's basis has been stepped up. See *supra* note 28.

231. See *Lamark Shipping Agency*, 1981 T.C.M. (P-H) ¶ 81,284; *GPD, Inc. v. Commissioner*, 60 T.C. 480 (1973), *rev'd*, 508 F.2d 1076 (6th Cir. 1974); *Ostendorf-Morris Co. v. United States*, 26 A.F.T.R.2d (P-H) ¶ 5369 (N.D. Ohio 1968). See generally Rudolph, *Stock Redemptions and the Accumulated Earnings Tax—An Update*, 4 J. CORP. TAX'N 101 (1977).

232. The charge against the earnings and profits account as a result of a redemption is calculated under the authority of *Helvering v. Jarvis*, 123 F.2d 742 (4th Cir. 1941) and Rev. Rul. 79-376, 1979-2 C.B. 133. See I.R.C. § 312(e).

accumulate instead of being divided or distributed." Once the tax is applicable, however, the tax base is "accumulated taxable income," or basically a current earnings figure with some adjustments then diminished by dividends but not by non-pro rata stock redemptions.²³³ The battleline thus is drawn. Taxpayer argues that it did not permit earnings to accumulate for the year in question. The IRS argues that current accumulation is unnecessary if there are accumulated earnings and profits and the requisite tax avoidance motive. Both positions are subject to criticism. Under the taxpayer's analysis, \$.01 of current earnings and profits is enough to trigger the tax on the total \$500,000 accumulated taxable income. On the other hand, the IRS is attempting to tax accumulated earnings in a year when there are no accumulated earnings.²³⁴

At the heart of the problem lies the favored treatment given to reinvested earnings on a redemption. In the example above, if \$500,000 had been distributed as an ordinary income dividend, no accumulated earnings tax problems would have arisen. However, when the corporation distributes its current earnings with only a capital gains toll charge to the shareholders, the Code shows signs of inconsistency. Clearly, some of the redemption proceeds originate from and should be charged to the earnings and profits account, and yet the accumulated earnings provision tends to force reasonable levels of current distributions, taxable at ordinary income rates.²³⁵

The incompatibility of the accumulated earnings concept and redemptions would disappear with the enactment of proposed section 300. The proposal forces redeeming shareholders to treat as ordinary income that portion of earnings and profits attributable

233. See I.R.C. § 531 for imposition of the penalty on accumulated taxable income. I.R.C. § 535 defines accumulated taxable income. I.R.C. §§ 561-565 define the dividends-paid deduction. I.R.C. § 562(c) eliminates non-pro rata stock redemptions from the dividends-paid deduction.

234. The IRS prevailed in *GPD, Inc. v. Commissioner*, 508 F.2d 1076 (6th Cir. 1974), in which the Sixth Circuit reversed the Tax Court. In *Lamark Shipping Agency*, 1981 T.C.M. (P-H) ¶ 81,284, the Tax Court, apparently unconvinced by the Sixth Circuit, noted the "fairly nettlesome legal issue," but declined to decide the issue because neither party raised it. 1981 T.C.M. at 974-81.

235. The inconsistencies of the Code are evident in I.R.C. §§ 312(a) and (e), which reduce earnings and profits on a redemption, and I.R.C. § 562(c), which prohibits any decrease in the accumulated earnings tax base for non-pro rata redemptions.

to the stock redeemed. Moreover, nonredeeming shareholders also will have ordinary income treatment under proposed section 300(4). Because any distributed earnings and profits will produce ordinary income to the shareholders, there is no need to apply the accumulated earnings tax provision when all of the earnings and profits for the years in question have been distributed.²³⁶

G. Reorganizations

Under existing law, it is often difficult to determine when a reorganization has taken place and when a corporation simply has distributed a taxable stock dividend. For example, a recapitalization in which some shareholders exchange some or all of their common stock for preferred is identical to a taxable stock dividend described in I.R.C. section 305(b)(3) when some common shareholders receive common and others receive preferred. Whether the exchange is taxable may turn on the frequency of the event. If the exchange is an isolated transaction that looks like a recapitalization, tax-free treatment will result; if the exchange is pursuant to a periodic plan to increase certain shareholders' proportionate interests, the recapitalization may be treated as a constructive distribution in accordance with I.R.C. section 305(c), subject to tax under section 305(b).²³⁷

In Revenue Ruling 75-93²³⁸ the IRS pushed this questionable distinction even further. There, the corporation had two classes of common stock outstanding with equal voting rights. The Class A common with a \$2.00 par value and the Class B common with a

236. To the extent that application of the accumulated earnings tax is diminished, courts would no longer have to wrestle with whether the hypothetical accumulated earnings (undiminished by the redemption) exceeded a taxpayer's reasonable business needs for the year or years in question. See I.R.C. §§ 533, 537. Compare, e.g., *Mountain State Steel Foundries v. Commissioner*, 284 F.2d 737 (4th Cir. 1960) (redemption of a dissenting minority shareholder held reasonable) with *Pelton Steel Casting Co. v. Commissioner*, 251 F.2d 278 (7th Cir. 1958), cert. denied, 356 U.S. 958 (1958) (redemption of majority shareholder held not reasonable).

237. See Treas. Reg. § 1.305-7(c). The only legislative explanation of the difference is a disclaimer made by Senator Long during the floor debate of I.R.C. § 305 of any intent to tax classic recapitalizations in which older, retiring shareholders exchange common for preferred, while younger shareholders, active in the business, increase their percentage of common. 115 CONG. REC. 37,902 (1969). See also Treas. Reg. § 1.305-3(e), Ex. 12.

238. Rev. Rul. 75-93, 1975-1 C.B. 101.

\$20 par value shared in dividends and liquidating distributions in a 10:1 ratio, commensurate with the par values. The corporation recapitalized for valid business reasons in accordance with I.R.C. section 368(a)(1)(E), with Class B shareholders receiving one Class A share for every seven instead of ten Class B shares. The result was an increase in the former Class B shareholders' proportionate interests in the assets and earnings of the corporation. Stressing the isolated nature of the transaction, the I.R.S. held the transaction not reachable by I.R.C. section 305(b).²³⁹

Although the IRS is content to let isolated disproportionate recapitalizations qualify for tax-free treatment, certain proportionate recapitalizations cause tax consequences when a shareholder receives stock in discharge of preferred arrearages.²⁴⁰ To illustrate: X Corp. has two classes of stock outstanding—ten shares of \$100 par 5% cumulative preferred, four years in dividend arrears, and ten shares of common stock. X Corp. has \$2,200 of assets including \$200 of earnings and profits. If X Corp. recapitalizes by issuing a new class of preferred worth \$120 for each share of the old preferred, I.R.C. sections 305(c) and (b)(4) will tax the preferred shareholders on \$20 per share;²⁴¹ yet, there have been no proportionate changes. Even though new pieces of paper have replaced old pieces, no corporate funds have been distributed and the taxpayers remain in their same relative positions. The preferred shareholders who had a claim for each share of stock on \$100 of X's assets plus \$20 for the dividend arrearages after the recapitalization hold stock certificates worth \$120 per share. The common shareholders who, prior to the recapitalization, held stock worth \$100 per share continue to do so.

Proposed section 300 analyzes the taxability of reorganizations in the same manner as other corporate distributions—by focusing on proportionate changes among shareholders. When proportionate interests change, as in Revenue Ruling 75-93, proposed section 300(4) would tax those shareholders whose interests are enhanced.

239. The IRS analogized an isolated recapitalization to an isolated redemption, which does not activate I.R.C. § 305(b) in spite of the increased proportionate interests in the assets, earnings, and profits of the corporation by the nonredeeming shareholders. See Treas. Reg. § 1.305-3(e), Exs. 10, 11, 13.

240. See Treas. Regs. §§ 1.368-2(e)(5), 1.305-7(c).

241. See Treas. Reg. § 1.305-5(d), Exs. 1, 2.

When proportionate interests remain constant, as in the recapitalization of stock arrearages, proposed section 300(4) would produce no tax consequences.

The adoption of proposed section 300 would impact the current reorganization provisions in other ways as well. A reorganization may offer an opportunity to dilute a large earnings and profits account among a number of shareholders, thereby decreasing the amount of ordinary income on the shareholders' eventual sale of the acquired stock. For example, A, sole shareholder of X Corp. with \$500,000 of earnings and profits, exchanges his stock for the stock of Y with no earnings and profits and forty-nine shareholders. The exchange qualifies as a B reorganization pursuant to I.R.C. section 368(a)(1)(B). Unless the earnings and profits account follows A, he will escape recognizing \$490,000 on any eventual sale of Y stock while the Y shareholders each would have to account for \$10,000 of ordinary income on any sale of their stock. In light of this potential bail-out, it may be advisable to force an acquiring shareholder in a reorganization to carry over his share of the acquired corporation's earnings and profits in his new stock. The argument for the carry over is strengthened by the fact that the acquiring shareholder does not have to share in the earnings and profits of the acquiring corporation that were amassed prior to the organization.²⁴²

The allocation of earnings and profits in a reorganization is a problem related to the treatment of boot by a shareholder. I.R.C. section 356(a)(1) provides for the recognition of any boot received to the extent of the shareholder's gain. I.R.C. section 356(a)(2) characterizes any gain recognized as ordinary income to the extent of a shareholder's ratable share of earnings and profits, if the exchange has the "effect of the distribution of a dividend."²⁴³ Based on dicta in *Commissioner v. Estate of Bedford*,²⁴⁴ the IRS initially

242. See proposed § 300(9) *supra* p. 18.

243. For a discussion of the amount and nature of gain recognized in a tax-free reorganization, see Golub, "Boot" in *Reorganizations—The Dividend Equivalency Test of Section 356(a)(2)*, 58 TAXES 904 (1980); Levin, Adess & McGaffey, *Boot Distributions in Corporate Reorganizations—Determination of Dividend Equivalency*, 30 TAX LAW. 287 (1977); Samansky, *Taxation of Nonqualifying Property Distributed in Reorganizations*, 31 CASE W. RES. L. REV. 1 (1980).

244. 325 U.S. 283 (1945). The Court's expansive language in *Bedford* was not necessary to

opted to treat boot as a dividend to the extent of the distributing corporation's earnings and profits.²⁴⁵ This "automatic dividend" rule eventually was eroded, however, leaving the IRS and the courts with I.R.C. sections 302 and 346 as standards for judging the "effect" of an exchange.²⁴⁶ In applying these standards, some confusion existed about whether to evaluate the effect of a distribution on a shareholder's stock ownership as though the redemption occurred before or after the reorganization.²⁴⁷ In Revenue Ruling 75-83, the IRS ruled that the transaction is a hypothetical redemption of the *acquired* corporation's stock.²⁴⁸

Proposed section 300 does not attempt to resolve the timing of the redemption analysis, but the receipt of boot in reorganizations generally is altered by the proposal to the same extent as redemption treatment. The dividend within gain concept of I.R.C. section 356(a)(1) would give way to a basic concept under proposed section 300: any distribution will produce ordinary income to the extent of the applicable measure of earnings and profits.²⁴⁹ To the extent that the distribution is pro rata to all shareholders of the acquired corporation, the distribution will be a dividend as measured by each shareholder's ratable share of earnings and profits.²⁵⁰ If boot

find dividend treatment when a distribution of cash during a recapitalization served to discharge preferred dividend arrearages.

245. See Rev. Rul. 56-220, 1956-1 C.B. 191; *Hawkinson v. Commissioner*, 235 F.2d 747, 750 (2d Cir. 1956).

246. See *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958), *cert. denied*, 358 U.S. 832 (1958) (IRS successfully argued against automatic dividend rule for corporate shareholder); Rev. Rul. 74-515, 1974-2 C.B. 118 (formal abandonment of automatic dividend rule). For application of the principles of I.R.C. §§ 302 and 346, see *Wright v. United States*, 482 F.2d 600, 607 (8th Cir. 1973); *King Enterprises v. United States*, 418 F.2d 511, 518 (Ct. Cl. 1969); *Ross v. United States*, 173 F. Supp. 793, 798 (Ct. Cl. 1959), *cert. denied*, 361 U.S. 875 (1959); Rev. Rul. 75-83, 1975-1 C.B. 112.

247. Compare *Wright v. United States*, 482 F.2d 600 (8th Cir. 1973) (treating distribution as post-merger redemption qualifying under I.R.C. § 302(a)) with *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979) (treating distribution as pre-merger redemption). See generally *Samansky*, *supra* note 243, at 23-28.

248. Rev. Rul. 75-83, 1975-1 C.B. 112. See also *Sellers v. United States*, 615 F.2d 1066 (5th Cir. 1980); *General Housewares v. United States*, 615 F.2d 1056, 1065-66 (5th Cir. 1980); *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978).

249. See FEDERAL INCOME TAX PROJECT ON SUBCHAPTER C—CORPORATE ACQUISITIONS (Tent. Draft No. 1, 1977), which provides for dividend treatment in appropriate circumstances regardless of gain.

250. See proposed § 300(6) *supra* p. 15.

is received in a non-pro rata distribution, the distribution, in accordance with existing law, will be treated as a redemption that may produce both ordinary income and capital gains consequences.²⁵¹

To illustrate: *A* and *B* are the sole shareholders of *X* Corp. with \$120,000 of earnings and profits. Each owns 100 shares with a basis of \$30,000 and a fair market value of \$120,000. *X* Corp. and *Y* Corp., a widely held public corporation, merge in accordance with I.R.C. section 368(a)(1)(A) with *A* and *B* each becoming less than 1% shareholders of *Y*. In the reorganization, *A* receives 100 shares or \$120,000 of *Y* Corp. stock in exchange for his *X* stock, and *B* receives fifty shares or \$60,000 of *Y* Corp. stock and \$60,000 in cash. Proposed section 300 treats the redemption as a distribution followed by a simultaneous contribution to capital and a redemption. Proposed section 300(4) treats the \$60,000 as pro rata distributions of \$30,000 to *A* and *B* which are taxed as ordinary income to the extent of the allocable earnings and profits.²⁵² *B*, whose stock in *X* Corp. was worth \$90,000 after the deemed distribution but prior to the redemption, owns \$60,000 of stock after the redemption. Accordingly, because *B* has exchanged one-third of his stock interest in a taxable transaction, \$10,000 of basis and \$10,000 of earnings and profits are allocable to the redemption.²⁵³ *A* raises his basis in the *Y* stock by \$30,000, the deemed contribution to capital under proposed section 300(5), and *B* recognizes an addi-

251. See proposed §§ 300(6), (7) *supra* pp. 15-16. Arguably, to the extent that the stock of the acquired corporation remains outstanding after the reorganization (*e.g.*, a B reorganization), the receipt of boot should be treated as sale proceeds. Treatment of boot as sales proceeds rather than redemption proceeds might affect the allocation of earnings and profits under proposed § 300(10). For ease of administration, perhaps boot should be treated as redemption proceeds in all reorganizations. See generally Golub, *supra* note 243 (arguing for sales treatment rather than redemption treatment for any boot received in an acquisitive reorganization).

252. See proposed §§ 300(6), (9) *supra* pp. 15, 18. To the extent that the acquiring corporation owns the acquired corporation, or both are commonly owned by the shareholder receiving boot, the earnings and profits of both corporations should be used as a measure. See the discussion of existing I.R.C. § 304 *supra* pp. 45-49. For a case using the earnings and profits of both the acquiring and acquired corporations, see *Davant v. United States*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

253. See proposed § 300(8) *supra* p. 17 (basis allocation = $\$30,000 \times 33.33\% = \$10,000$) and proposed § 300(10) *supra* p. 19 (earnings and profits allocation = $\$30,000 \times 33.33\% = \$10,000$).

tional \$10,000 of ordinary income and \$10,000 of capital gain on the redemption aspect, leaving him with a \$20,000 basis in his Y stock.²⁵⁴ A and B would each carry over his ratable share of earnings and profits to the Y stock.²⁵⁵ The effect, then, of proposed section 300 on the reorganization provisions is only as significant as its effect on dividends and redemptions in general. The proposal does not address independently current reorganization treatment.

IV. CONCLUSION

The genesis of proposed section 300 lies in the inconsistent treatment of a corporation's earnings and profits depending on whether they are distributed or reinvested with shareholders reaping their benefit through sale or redemption. By creating a tax-neutral framework within which earnings and profits are taxed as ordinary income regardless of their mode of exit from the corporation, proposed section 300 would provide identical tax treatment for identical economic results. The virtues of the proposal include a consistency that would allow transactions to be planned around business rather than tax considerations. Existing provisions and doctrines that fester with complexity and ambiguity, for example, I.R.C. section 306 or bootstrap acquisitions, would no longer be needed to patch up the existing system where the leak of earnings and profits into the capital gains receptacle becomes too pronounced. Corporations that previously had retained earnings for eventual transformation into capital gains might be more inclined to distribute them. Because the earnings will be taxed as ordinary income whether realized by sale, redemption, or liquidation, distribution on a current basis might avoid any bunching problem. If the proposal resulted in a tendency towards more current distribution, the result, arguably, would be less economic distortion because investors would be free to pursue investments with the best return.²⁵⁶ Whether the proposal would create a lock-in effect due to the ordinary income potential on a sale of stock is speculative. Incentive exists not to wait to sell as the unrealized ordinary income in stock increases and bunching becomes more significant.

254. See proposed §§ 300(6), (7) *supra* pp. 15-16.

255. A would carry over \$30,000 of earnings and profits, and B would carry over \$20,000.

256. See PECHMAN, *supra* note 26, at 146; POSNER, *supra* note 29, at 378.

Yet, the promise of a step-up in basis at death perhaps becomes more urgent as the capital gains advantage is weakened.²⁵⁷

Admittedly, implementation of proposed section 300 is not problem free. Aside from potential lock-in incentive, the unrealized ordinary income in a share of stock arising from reinvested earnings over a period of years creates a potential bunching problem, forcing shareholders into higher brackets. To the extent shareholders do not compel current distributions or do not sell their stock on a current basis, the bunching represents shareholder choice. Moreover, the income averaging provisions of I.R.C. sections 1301 to 1305 can relieve the problem. Perhaps the most significant problem arising out of the proposal is its heavy emphasis on valuation as well as earnings and profits allocation. The problems of allocating earnings and profits among stock classes and accounting for the appropriate measure of earnings and profits on each sale may require new reporting and accounting requirements by corporations. Perhaps the enactment of a *de minimus* rule could soften the blow. In spite of the difficulties, proposed section 300's emphasis on valuation and the economic effect of transactions rather than on motive or other qualitative judgments as to form, or on the arbitrary judgments of provisions such as I.R.C. sections 302 and 305, is more appropriate for judicial resolution.

If, after weighing the pros and cons of a system along the lines of proposed section 300, the scale tips toward rejection, perhaps an alternative solution could address the disparity in the treatment of reinvested earnings. Rather than conforming the treatment of sale or redemptions to the treatment of dividends with respect to the earnings component, all dividends might be given capital gains treatment. This alternative solution, like proposed section 300, would have the advantage of uniformity which is sadly lacking under the Code's existing mongrel provisions.

257. As discussed *supra* note 28, stock inherited after death would have an unrealized ordinary income component, although the step-up in basis might provide an offsetting capital loss on a sale subject to the limitations of I.R.C. §§ 1211 and 1212. If I.R.C. § 1014 were amended to eliminate a step-up to the extent of the stock's allocable earnings and profits, it is unclear how the lock-in effect might be altered. See PECHMAN, *supra* note 26, at 137.

APPENDIX

PROPOSED SECTION 300

- (1) The term "distribution" means a payment of property with respect to or in redemption of the corporation's stock.
- (2) The term "property" includes money, securities, and stock in the corporation making the distribution, or rights to acquire such stock.
- (3) The term "redemption" means the acquisition by a corporation of its stock from a shareholder in exchange for property, whether the stock so acquired is cancelled, retired, or held as treasury stock.
- (4) Any actual distribution with respect to a class of stock is deemed to be pro rata to the shareholders holding such stock. Any actual distribution in redemption of a class of stock is deemed to be pro rata to the shareholders holding such stock or a less preferred class of stock to the extent that the value of such shareholders' stock increases as a result of the surrender of shares. Distributions of the distributing corporation's own stock shall have no tax consequences unless the distribution increases the proportionate interests of the receiving shareholders in the assets or earnings and profits of the corporation.
- (5) Any transfer of stock by sale or exchange shall be treated as a redemption and a simultaneous purchase from the corporation. Any transfer of stock by redemption shall be treated as a redemption and a simultaneous contribution to capital of the corporation by the remaining shareholders both in the amount of the deemed distribution.
- (6) On any distribution, a shareholder shall treat as ordinary income any proceeds to the extent of his ratable share of earnings and profits. On any transfer by sale, exchange, or redemption, a shareholder shall treat as ordinary income any proceeds to the extent of his ratable share of earnings and profits attributable to the stock transferred.
- (7) Any amounts distributed in excess of a shareholder's ratable share of earnings and profits shall first be applied against a shareholder's basis in his stock (but not in excess of basis allocable to any stock transferred), and then be treated as gain

- from the sale or exchange of property.
- (8) In determining gain on a transfer, the basis of stock transferred equals the product of a shareholder's basis in the class of stock transferred and the percentage decrease in the shareholder's stock ownership of that class as a result of the transfer.
 - (9) A shareholder's ratable share of earnings and profits equals the sum for all years of the product of the current earnings and profits allocable to any class of stock on which a distribution is made and the shareholder's percentage of stock ownership of such class on January 1 of the year.
 - (10) The term "ratable share of earnings and profits attributable to the stock transferred" means the product of the shareholder's ratable share of earnings and profits and the percentage decrease in the shareholder's stock ownership in the class of stock transferred as a result of the transfer.