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Boot Distributions under the '54 Tax Code

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BOOT DISTRIBUTIONS UNDER THE '54 TAX CODE

Various provisions of the 1954 Internal Revenue Code dealing with income taxation have deferred the recognition of gain or loss on certain corporate readjustments.[1] This deferral of taxation is based on the realization that normal business transactions would be impeded if a tax were to be imposed upon realignments of corporate interests which are inspired by business vicissitudes and which do not effect a substantial change in the ownership of property. This attitude is a logical extension of the basic norm that unrealized appreciation or depreciation in the value of property does not in itself give rise to any tax consequence.[2] Gain or loss is recognized for tax purposes only if there has been a sale or other disposition of the property which constitutes a completed transaction.

The boot provisions of the Code are intended to eliminate possible abuse of the tax deferring provisions.[3] These provisions serve a dual function. They assure that where

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1 INT. REV. CODE OF 1954, §§ 354, 368, dealing with corporate reorganizations; INT. REV. CODE OF 1954, § 351, dealing with transfers to controlled corporations; and INT. REV. CODE OF 1954, § 355, dealing with divisive reorganizations. Sections of the Internal Revenue Code of 1954 will hereafter be referred to by section number.

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

3 § 354 provides for tax-free exchanges of stock or securities on a reorganization as follows:

"(a) GENERAL RULE.—

(1) *In General.*— No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) *Limitation.*— Paragraph (1) shall not apply if —

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered."

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money or similar property is received as a result of an otherwise tax-free exchange in connection with a corporate reorganization, a tax will be imposed on the gain, if any, limited to the value of the money or other property received. The boot provisions also operate to prevent the

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[3] *Continued from page 414*

§356 provides for the taxation of boot received in reorganzations to which §354 is applicable and distributions under §355 as follows:

"(a) GAIN ON EXCHANGES. —

(1) *Recognition of gain.* — If —

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) *Treatment as dividend.* — If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(b) ADDITIONAL CONSIDERATION RECEIVED IN CERTAIN DISTRIBUTIONS. — If —

(1) section 355 would apply to a distribution but for the fact that

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

then an amount equal to the sum of such money and the fair market value of such other property shall be treated as a distribution of property to which section 301 applies.

(c) Loss. — If—

(1) section 354 would apply to an exchange, or section 355 would apply to an exchange or distribution, but for the fact that

(2) the property received in the exchange or distribution consists not only of property permitted by section 354 or 355 to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange or distribution shall be recognized.

(d) SECURITIES AS OTHER PROPERTY. — For purposes of this section —

(1) *In general.* — Except as provided in paragraph (2), the term "other property" includes securities.

(2) *Exceptions.* —

(A) Securities with respect to which non-recognition of gain would be permitted. — The term "other property" does not in-

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unjustifiable conversion of ordinary income into capital gain as a result of a corporate reorganization.

The Code permits certain corporate realignments to be

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3 *Continued from page 415*

clude securities to the extent that, under section 354 or 355, such securities would be permitted to be received without the recognition of gain.

(B) Greater principal amount in section 354 exchange. — If —

(i) In an exchange described in section 354 (other than subsection (c) thereof), securities of a corporation a party to the reorganization are surrendered and securities of any corporation a party to the reorganization are received, and

(ii) the principal amount of such securities received exceeds the principal amount of such securities surrendered,

then, with respect to such securities received, the term "other property" means only the fair market value of such excess. For purposes of this subparagraph and subparagraph (C), if no securities are surrendered, the excess shall be the entire principal amount of the securities received.

(C) Greater principal amount in section 355 transaction. — If, in an exchange or distribution described in section 355, the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities in the distributing corporation which are surrendered, then, with respect to such securities received, the term 'other property' means only the fair market value of such excess.

(e) EXCHANGES FOR SECTION 306 STOCK.—Notwithstanding any other provision of this section, to the extent that any of the other property (or money) is received in exchange for section 306 stock, an amount equal to the fair market value of such other property (or the amount of such money) shall be treated as a distribution of property to which section 301 applies."

§351 provides tax free transfers to controlled corporations and for the taxation of boot received on such transfers as follows:

"(a) GENERAL RULE. — No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

(b) RECEIPT OF PROPERTY. — If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock or securities permitted to be received under subsection (a), other property or money, then —

(1) gain (if any) to such recipient shall be recognized, but not in excess of —

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized."

accomplished if they are connected with the organization or reorganization of a company. If the technical provisions of the Code and the additional requirements made necessary by court decisions[4] are met, no tax results at the corporate level. As a corollary, no tax is imposed at the shareholder level so long as the shareholder merely receives or exchanges stock or securities of corporations which are parties to the reorganization. If other property or money is received, a tax may be imposed on the shareholder by operation of the boot provisions.

I. Boot Defined

For the purposes of this article, boot shall include money and all other property which cannot be received tax-free under the various tax deferral provisions of the Code.[5]

Stock or securities of a party to a reorganization can be exchanged tax-free for stock or securities of another party to the reorganization. Under certain circumstances stock or securities of a party to a reorganization can be received tax-free without involving an exchange. If money or other

[4] Gregory v. Helvering, 293 U.S. 465 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933); Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir), *cert. denied*, 342 U.S. 860 (1951); Bassick v. Commissioner, 85 F.2d 8 (2d Cir.), *cert. denied*, 299 U.S. 592 (1936) (step transactions); Friedman and Silbert, *The "Continuity of Interest" Test in Bond for Stock Recapitalizations*, N.Y.U. 11th Inst. on Fed. Tax. 361 (1953) (continuity of interest); Michaelson, *"Business Purpose" and Tax-Free Reorganization*, 21 Yale L. J. 14, (1952) (business purpose).

[5] §354(a) provides that no gain or loss shall be recognized if stock or securities of a party to a reorganization are exchanged "solely" for stock or securities of a party to the reorganization.

The word "solely" is modified by the provisions of §354(a)(3) and §356(a)(1), which permit the addition of other property or money without disturbing the tax-free aspects of that part of an exchange which qualifies under §354(a). However, §356(a)(1) makes it clear that there must be a tax-free exchange in order for the boot provisions to be operative. If only property or money, which would otherwise qualify as boot, is received and no stock or securities which qualify for tax-free treatment under §354(a) are also received, then the boot provisions are inoperative. U.S. Treas. Reg. §1.356-1 (1955).

property (other than stock or securities of a party to the reorganization) is received, it is treated as boot.

If the reorganization is divisive, stock or securities of a controlled corporation which were acquired in a taxable transaction within five years of the distribution would be boot.[6] Further, if the principal amount of the securities received is greater than the principal amount of the securities surrendered, the market value of the excess is boot.[7]

In the case of the transfer of property to a controlled corporation, boot includes money and property received by the transferor other than stock or securities of the controlled corporation.[8] The term "securities" for this purpose includes, by judicial definition, corporate obligations which by their terms will be outstanding for a substantial period. Obligations which have short maturity dates do not qualify and therefore will be treated as boot.[9] Stock rights or warrants are treated as boot even though they are issued with respect to stock or securities of a party to the reorganization.[10]

II. Reorganizations In Which Boot May Be Received

The Code enumerates various types of corporate realignments which qualify as reorganizations.[11] The definition of some of the realignments limits the amount of boot which may be received without disqualifying the transaction as a tax-free reorganization.

Merger[12] and recapitalization[13] are the more common forms of reorganization which give rise to boot distribu-

6 §355(a)(3).

7 §356(d); §355(a)(3).

8 §351(b).

9 Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).

10 U.S. Treas. Reg. §1.354-1(e).

11 §368(a)(1).

12 §368(a)(1)(A).

13 §368(a)(1)(E).

tions. The statutory definitions of these reorganizations do not limit or prohibit the distribution of boot.[14]

The acquisition of a corporation by another "solely" for voting stock, a (B) reorganization,[15] can be effected, by definition, only if the exchange by the acquiring company is solely for voting stock. The word "solely" is an essential element of the definition and leaves no leeway for the inclusion of boot. If the acquiring corporation exchanges anything other than its voting stock, there is no reorganization. The opinion in *Howard v. Commissioner*[16] is contrary and holds that the boot provisions are applicable when stock and cash are received on an exchange.

In effect, the *Howard* case holds that the boot provisions are a gloss on the definition of a (B) reorganization and that the use of the word "solely" in the reorganization definition is mitigated by the boot provisions which permit the inclusion of other property. There is no sound reason for prohibiting a boot distribution in connection with a (B) reorganization while permitting a boot distribution in other types of reorganizations. The result in the *Howard* case does not differentiate among types of reorganizations. However, in reaching this equitable result the Court of Appeals for the Seventh Circuit apparently chose to ignore the language of the statute and judicial interpretation[17] of similar language in prior statutes. For this reason, until

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14 The court-made rules are fully applicable. Thus a boot distribution might disqualify a merger or a recapitalization as tax-free if the continuity of interest test is not satisfied.

15 §368(a)(1)(B). The various types of corporate realignments which constitute a corporate reorganization under §368(a) commonly are referred to by the number of the subsection describing them.

16 238 F.2d 943 (7th Cir. 1956).

17 Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942); Pressed Steel Car Co. v. Commissioner, 152 F.2d 280 (3d Cir. 1945), *cert. denied*, 328 U.S. 838 (1946); Central Kansas Telephone Co. v. Commissioner, 141 F.2d 213 (10th Cir. 1944); Commissioner v. Air Reduction Co., 130 F.2d 145 (2d Cir.), *cert. denied*, 317 U.S. 681 (1942). The first three cases involved a (C) reorganization, but the rule would be equally applicable in a (B) reorganization. The reasoning of the Supreme Court in the *Southwest Consolidated* case seems fully applicable to a (B) reorganization.

the statute is amended or the principle of the *Howard* case is approved by the Supreme Court, it is safer to assume that there can be no distribution of boot in a (B) reorganization.

The prior acquisition of stock for cash (creeping control) is now permitted in a (B) reorganization but if the cash acquisitions are connected with acquisitions for voting stock, then the exchange does not qualify.[18]

The acquisition of substantially all of the properties of another corporation in exchange for voting stock, a (C) reorganization,[19] can involve the distribution of boot on the shareholder level without disturbing the reorganization. The boot may be received on the dissolution of a corporation whose assets were exchanged for voting stock of the acquiring corporation.[20] However, the amount of boot which can be distributed is limited by the fact that the dissolving corporation must have exchanged substantially all of its properties for voting stock of the acquiring corporation.[21] The acquiring corporation then is permitted to include cash or other property in exchange for twenty percent or less of the value of the property received from the transferee corporation; for the purpose of making the computation, however, liabilities are treated as money. As a practical matter, therefore, the acquiring corporation would be permitted to transfer very little, if any, boot under this provision and still satisfy the requirements of the section.[22]

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18 U.S. Tras. Reg. §1.368-2 (c) (1955).

19 §368(a)(1)(C).

20 An exchange by the stockholders of the disolving corporation for stock of the acquiring corporation (assets received on dissolution) qualifies as a tax-free exchange under §354 since both companies were parties to the reorganization. §368(b)(2).

21 Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939), *appeal dismissed,* 309 U.S. 691 (1939); Schuh Trading Co. v. Commissioner, 95 F.2d 404 (7th Cir. 1938); Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937); Western Industries Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936).

22 See McDonald and Willard, *Tax-Free Acquisitions and Distributions,* N.Y.U. 14TH INST. ON FED. TAX., 859, 881 (1956).

The transfer of part of a corporation's assets to another corporation, if the transferor or its stockholders are in control of the transferee, a (D) reorganization,[23] can be effected only as part of a divisive reorganization under section 355. A boot distribution can be made as part of a divisive reorganization without disturbing the tax-free aspects of the reorganization.

III. Taxation Of Boot

Boot received on an exchange is taxable only if the recipient realizes a gain on the transaction. The gain is measured by the difference between the tax basis for the stock or securities exchanged compared with the aggregate value of all property received, including tax-free items. If the gain exceeds the value of the boot, the gain recognized for tax purposes is limited to the value of the boot. If the gain is less than the value of the boot, then the entire gain is recognized. In short, the gain recognized will be the amount of the gain or the value of the boot, whichever is less. The gain recognized is taxed as a dividend to the extent that the distribution has the effect of a dividend payment and the remainder is treated as an amount received on the exchange of property.

Boot received in an exchange for section 306 stock is treated as a dividend to the extent of the earnings of the issuer of the stock, without regard to realization of gain on the transaction.[24] Boot received in a divisive reorganization, not involving an exchange, is also taxable as a dividend to the extent of corporate earnings regardless of gain on the transaction. In both cases the balance of the boot not taxed as a dividend is applied in reduction of basis and any excess is taxed as a gain on the exchange of property.

Loss realized by a recipient of boot is never recognized

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23 §368(a)(1)(D).

24 §356(e), dividend treatment is limited only by §301.

for tax purposes.[25]

Under Section 358(a)(2), the basis of boot, other than money, received in a reorganization is its fair market value as of the time that the boot was distributed. The holding period of boot begins on the date of its distribution since there is no contrary provision in Section 1223.

IV. DIVIDEND TREATMENT OF BOOT

Gain realized in a boot distribution in connection with an exchange on a reorganization may be taxable as dividend income. The Code is cryptic in defining the extent to which taxable boot will be treated as dividend income. It begs the question by providing that gain is to be taxed as a dividend if the distribution of boot has the effect of a dividend distribution.[26] The amount taxable as a dividend is limited to the amount of boot or the recipient's ratable share of corporate earnings and profits, whichever is less.

The early cases[27] which applied the statutory rule determined that dividend treatment was automatic to the extent that the recipient's ratable share of corporate earnings was sufficient to cover the boot distributed to him. None of these cases limited dividend treatment to situations where the reorganization sections were used as a means of distributing corporate earnings at capital gains rates although this appears to be the legislative intent in incorporating the provision in the statute.[28]

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25 §356(c); §351(b)(2).

26 §356(a)(2).

27 Campbell v. United States, 144 F.2d 177 (3d Cir. 1944); Love v. Commissioner, 113 F.2d 236 (3d Cir. 1940); Rose v. Little Investment Co., 86 F.2d 50 (5th Cir. 1936); Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934); Commissioner v. Forhan Realty Corp., 75 F.2d 268 (2d Cir. 1935).

28 Revenue Act of 1918, §202(b), 40 STAT. 1060, provided that no gain or loss should be recognized on an exchange of stock or securities in connection with a reorganization, merger or consolidation if the stock or securities received in exchange had no greater par or stated value than those exchanged. The excess of par or stated value was treated as boot and

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The Supreme Court approved the "automatic dividend" rule in the *Bedford*[29] case. In the recent *Northup*[30] case, however, the Court of Appeals for the Second Circuit, in dealing with an analagous statutory provision, applied a "net effect" test. The latter test applies dividend treatment only if the boot distribution is equivalent to and has the same consequences as the payment of a cash dividend. This "net effect" test may prove to be a refinement of the "automatic dividend" rule and therefore consistent with it. As

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taxed as a gain on the securities exchanged.

Revenue Act of 1921, §202(e), 42 STAT. 229, permitted a tax-free exchange of stock and securities of corporations which were parties to a reorganization, regardless of par or stated value, but provided that any other property or money received should be applied against the basis of the stock or securities exchanged and taxed only to the extent of the excess.

Revenue Act of 1924, §203(b) (2), 43 STAT. 256, provided that no gain or loss should be recognized if stock or securities were exchanged in pursuance of a plan of reorganization. Revenue Act of 1924, §203(d) (1),(2), 43 STAT. 257, then provided that if gain—measured by the value of all items received—was realized on a boot distribution in such transactions, the gain—limited to the value of the boot—should be taxed as a dividend if the boot had the "effect of the distribution of a taxable dividend" and that the balance should be taxed as a gain on the exchange of property.

1939-1 (Part 2) CUM. BULL. 266, 277, commented on the reason for the amendment providing for dividend treatment as follows:

> "Section 203 (d) (2): There is no provision of the existing law which corresponds to paragraph (2) of subdivision (d). This paragraph provides that any amount distributed by a corporation in connection with a reorganization which has the effect of a taxable dividend shall be taxed as a dividend.
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> "The necessity for this provision may best be shown by an example: Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
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> "On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12½ per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then an amount so distributed should also be subject to the surtax rates and not to the 12½ per cent rate on the capital gain."

29 325 U.S. 283 (1945).

30 Northup v. United States, 240 F.2d 304 (2d Cir. 1957).

will be seen below, application of the net effect test to the facts in the *Bedford* case would not change the result reached by the Supreme Court. However, application of the net effect test to other boot distributions would have prevented dividend treatment.

The *Bedford* case involved an exchange, in a recapitalization, of preferred stock with dividend arrearages for a new preferred, common, and cash. The cash was taxed as a dividend. The Court did not discuss the treatment of boot received on preferred where boot exceeds dividend arrearages. As a matter of corporate law, a distribution on preferred stock which exceeds its dividend arrearages can only be made as a partial redemption of the issue. The boot provisions limit dividend treatment to the issue's ratable share of the company's earnings. In the normal exchange, therefore, dividend treatment on preferred stock should be limited to its dividend arrearages.[31] The same result should follow by application of either the "automatic dividend" rule or the "net effect" test.

If boot is received on common stock, the only certain restriction on dividend treatment is the fact that its ratable share of corporate earnings is less than the value of the boot received. The sweeping language of the *Bedford* case indicates that dividend treatment is automatic in such cases.

In Rev.Rul. 56-220,[32] cash was distributed in lieu of fractional shares on an exchange of common stock on the merger of two banks. The cash was held taxable as a dividend since the company had sufficient earnings to cover the distribution. This is an extreme application of the "automatic dividend" rule since there was a valid business

[31] This presupposes that the reorganization itself is founded in a sound business purpose. If the reorganization is used as a device to siphon out corporate earnings, the boot section would not afford immunity against dividend treatment. Adams v. Commissioner, 331 U.S. 737 (1947).

[32] 1956-1 CUM. BULL. 191.

reason for the cash distribution and the cash was distributed only to shareholders who would have been entitled to fractional shares of new stock.

The *Northup* case, in effect, rejects this application of the "automatic dividend" rule and applies the "net effect" test in an analogous situation.[33] *Northup* involved dividend treatment on the redemption of preferred stock by a closely held corporation. Some of the preferred stockholders owned common but others did not. The percentage of preferred owned by common stockholders was not in proportion to their ownership of the common stock. The lower court held that the redemption of preferred in the hands of stockholders who also owned common was essentially equivalent to a dividend and should be taxed as such.[34]

The court of appeals reversed and held that the redemption was not essentially equivalent to a dividend since it did not produce the same end result as a declaration of a cash dividend. By analogous reasoning, a distribution of cash in a reorganization in lieu of fractional certificates would not be treated as a dividend.

The "net effect" test applied to a boot transaction would require that all holders of the same class of stock receive boot in proportion to their holdings. If the proportion exists and if the result, in so far as the corporation is concerned, is the same as if a dividend consisting of the boot had been declared, then the transaction may be said to have the same effect as the distribution of a dividend. The "net effect" test does not mean that boot must be treated as a dividend to all stockholders before dividend treatment

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[33] The *Northup* case, *supra*, note 30, involved dividend treatment on the redemption of preferred stock under §115(g), INT. REV. CODE of 1939, 53 STAT. 48. That section provided for dividend treatment if the distribution was "essentially equivalent to the distribution of a taxable dividend." There appears to be no reason why similar rules should not be applied under the "effect of the distribution of a dividend" language of §356(a)(2) as were applied under §115(g) of the 1939 Code.

[34] Northup v. United States, 137 F. Supp. 268 (1955).

will be applied to any. For example, the result of the *Bedford* case would not be altered because other stockholders had losses and therefore were not subject to tax on the cash distributed to them.

The *Northup* case is the only recent case which articulates the "net effect" test. As previously indicated, the case did not arise under the boot sections but its rationale is equally applicable in determining the extent to which boot distributions are subject to dividend treatment. The "net effect" test may be viewed as a refinement of the "automatic dividend" rule since similar results follow from the application of the "net effect" test to most cases in which the "automatic dividend" rule was applied. The conflicting results which follow from the application of the "net effect" test to other cases which applied the "automatic dividend" rule may demonstrate that the "automatic dividend" rule was misapplied in those cases rather than an indication that the two standards are in conflict. While it is too early to state authoritatively which of the standards will prevail if there is, in fact, a conflict between them, the "net effect" test seems more consistent with the congressional intent and should, on that ground, ultimately prevail over the arbitrary standard established by the "automatic divided" rule.

V. Debentures Received In A Reorganization

The amendments to the boot provisions made by the 1954 Code have restricted the flexibility formerly permissible. Under the 1939 Code a company having preferred outstanding with dividend arrearages could offer, by recapitalization or merger, to exchange any combination of stock and debentures (so long as the continuity of interest test was satisfied) for the old preferred without tax consequences to the preferred stockholders.[35] The tax-free treatment of the exchange meant that a preferred stockholder would be influenced to vote for or against the proposed plan on its economic merits.

Under the 1954 Code, coupling debentures and stock on an exchange for preferred or common brings the boot provisions into operation.[36] If the preferred is exchanged for stock and debentures and the holder of the preferred has a gain on the transaction, the gain will be taxable as dividend income to the extent of dividend arrearages.[37] The balance of the gain, to the extent of the value of the debentures, less the amount taxed as a dividend, will be treated as a gain on the sale of property. If, on the other hand, the package offered in exchange for the preferred is limited to debentures and cash, the holder of the preferred will not be subject to the boot provisions. The entire transaction will then be treated as a redemption of the preferred stock.[38] The gain realized on the transaction will be fully taxable but the gain, except in unusual cases, will be treated as a gain realized on the sale or exchange of property.[39] Furthermore, any loss sustained on the transaction, unlike a transaction subject to the boot provisions, will be recognized.

In Rev. Rul. 56-179,[40] the Treasury Department ruled on a recapitalization of a preferred stock which was con-

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35 Davis v. Penfield, 205 F.2d 798 (5th Cir. 1953); Daisey Seide, 18 T.C. 502 (1952); Wolf Envelope Co., 17 T.C. 471 (1951); Annis Furs, Inc., 2 T.C. 1096 (1943); Clarence J. Sahoo, 47 B.T.A. 459 (1942); L & E Stirn, Inc., 39 B.T.A. 143, *rev'd on other grounds*, 107 F.2d 390 (2d Cir. 1939).

36 Only securities having a face amount equal to those surrendered can be received tax-free; the fair market value of the balance is boot. §356(d).

37 Assuming, of course, that the company has earnings and that the applicable dividend test (automatic or net effect) is satisfied.

38 If no stock is received on the exchange it does not qualify under §354, and §356 does not come into operation. U.S. Treas. Reg. §1.354—1(d) (1955).

39 §302.

40 1956-1 CUM. BULL. 187.

vertible into common stock. The preferred was called for redemption and each holder had the following options: (1) convert the preferred into seven shares of common; (2) receive a $100.00 debenture, a share of common, and cash equal to accrued dividends on the preferred; (3) receive cash equal to the redemption price of $100.00 per share on the preferred plus accrued dividends.

The Treasury ruled that no gain or loss was realized by stockholders electing option (1). The entire transaction was tax-free as an exchange on a reorganization without a boot distribution. Stockholders selecting option (2) were taxed on their gain, if any, limited to the value of the debentures and cash (boot). The transaction qualified as an exchange under the reorganization sections since common was received for the preferred but it was taxable to the extent of the boot received. The gain was taxed as a dividend to the extent of the dividend accruals on the preferred and the balance as a gain realized on the exchange of property. No loss was recognized. Gain or loss realized by those selecting option (3) was recognized. The exchange did not qualify under the reorganization sections since no stock was received on the exchange. The boot provisions were inapplicable. No part of the gain realized by a shareholder was taxed as a dividend.

This ruling suggests the advantages of recapitalizing preferred stock on an optional basis to stockholders. A recapitalization of preferred stock rarely is possible except with the preferred stockholders' approval as a class, or on a voluntary exchange basis. The tax consequences to a particular holder of the preferred stock will be a major element influencing his decision as to whether he should tender his stock on a voluntary exchange or vote in favor of a forced exchange. If the exchange offered by the company includes a boot distribution, the company will be unable to advise the preferred stockholders, as a group, except in general terms, precisely what the tax consequences of the exchange to an individual stockholder would be.

Perhaps more important is the fact that the company cannot accurately estimate the attractiveness of a plan which includes boot to the stockholders to whom the plan is offered. The exact tax results depend upon information available only to the individual stockholder. If a stockholder has a high cost basis for the stock exchanged and consequently no gain on the transaction, it will be immaterial to him, and perhaps preferable, that the company include boot items.

On the other hand, the inclusion of boot items in the case of a stockholder who has a gain on the transaction will mean that the stockholder will realize a taxable gain, part of which may be taxable as ordinary income. Such a stockholder might find an exchange offer which includes stock and debentures and no cash objectionable. The inclusion of the debentures would result in a cash outlay on his part equal to the tax payable by him on account of the distribution of boot. Of course, he could finance the tax cost by a sale of part of the package received in exchange for his old stock, but he justifiably might feel that he should maintain his old position in the company and avoid the payment of any tax.

A distribution of cash or debentures, or a combination of both, might be most attractive to a stockholder who realizes a loss on the transaction. The boot provisions would be inapplicable and the stockholder could deduct his loss for tax purposes. Similarly, a stockholder realizing substantial dividend income as a result of a boot distribution might prefer a package plan which does not qualify under the reorganization sections. He might prefer having his gain taxable at capital gain rates.

A plan giving stockholders an election as to the form of recapitalization to be followed should bring the greatest favorable response. If the plan is formulated for sound business reasons, an optional offer to stockholders should be valid for tax purposes. On the other hand, the Government might argue in situations where tax avoidance was the primary objective that all stockholders should be taxed on a uniform basis.[41]

The result arrived at in the ruling is inconsistent with the net effect test. The stockholders who elected to convert their preferred into common received nothing which could be considered a dividend. They received no proportionate part of any putative distribution of earnings and, therefore, there was no distribution to all of the stockholders (including those who elected to receive debentures and cash or stock, debentures and cash) which had the effect of the distribution of a dividend. This could be the case only if all participants received a distribution of debentures or cash. Thus no part of the gain recognized to a stockholder receiving boot should have been taxed as dividend income.

VI. Boot Received On Bonds Having Accrued Interests

The accrued interest due on bonds which are exchanged in a reorganization is not severable from the bond itself. The bond and the interest are an integral unit. The unit is treated as a security under the reorganization and boot sections. If no boot is received on an exchange of bonds, the transaction is tax-free even though part of the package received in exchange is designated as a payment of accrued interest on the bonds. Moreover, if boot is received

[41] U.S. Treas. Reg. §1.305-2 (1955), provides that distributions of stock dividends shall be taxable as a dividend if the stockholder has an election to receive payment in cash. Analogous reasoning might be applied in the case of elections connected with a reorganization.

the taxable portion of the boot will be treated as a gain on the sale of property and no part of it will be allocated to the receipt of interest.

In *Commissioner v. Carman*,[42] on a corporate reorganization, the taxpayer exchanged bonds for cash, bonds, and preferred and common stock. The common stock was identified in the plan as a payment for interest accrued on the old bonds to January 1, 1939, the effective date of the plan. The original plan was to be effective as of January 1, 1939, and did not include a cash payment. The plan was not consummated until 1944, and the cash payment was added as an adjustment for interest and dividends which would have been paid on the new bonds and common stock in the interim.

The Government argued that the common stock should be taxable as ordinary income since it was distributed in payment of the interest due on the old bonds. The court held that the designation of the common stock as a payment in satisfaction of the interest was immaterial for tax purposes. The accrued interest on the bonds was considered as part of the security exchanged and the receipt of the bonds, preferred and common stock therefore was taxfree under the reorganization provisions of the Code.

In addition, the Government contended that the cash payment made to adjust for interest and dividends which would have been received from 1939, the effective date of the plan, to 1944, the consummation date of the plan, should be taxed as interest on the new bonds and dividends on the new stock. On this point, the court held that the cash payment attributable to the interest was boot received on the old bonds. The gain, to the extent taxable, was treated as gain realized on the sale of property. The boot provisions treat gain as ordinary income only if the distribution has the effect of a dividend, and gain realized

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42 189 F.2d 363 (2d Cir. 1951).

on an exchange of bonds does not fall within that classification. A different approach, leading to the same result, was applied to the cash attributable to dividends on the new stock. Such money could not be taxed as ordinary income in the absence of proof that the company had sufficient earnings to cover the distribution. Consequently, capital gain treatment was directed. The reasoning of the court with respect to the treatment of the two cash items is inconsistent.[43] However, the end result reached was the same as that which would have resulted if all of the boot had been taxed as received on the old bonds.

VII. Boot Received In Divisive Reorganizations

The boot provisions are applicable to a divisive reorganization. Section 355 permits a tax-free distribution in a spin-off, split-up or split-off if the requirements of the section are met with respect to the conduct of two or more separate trades or businesses for over five years.[44]

There is a very material difference in the treatment of boot received in a split-off or split-up as opposed to a spin-off. A *split-up* occurs where a parent corporation distributes stock of two or more subsidiaries in exchange for all of its stock and then dissolves. A *split-off* occurs where a corporation distributes the stock of a subsidiary or subsidiaries in exchange for part of its stock. A *spin-off* is similar to a split-off. The corporation distributes stock of a subsidiary or subsidiaries but does not receive any of its own stock in return. There is no exchange of stock in-

[43] The cash received on the bonds was considered a boot distribution on the old bonds which could be taxed only as a gain on an exchange; logically, the cash received on account of dividends on the new stock should have received similar treatment and the court should not have gone into the question of accumulated earnings.

[44] The definition of boot is expanded in the case of divisive reorganizations to include stock or securities of the controlled corporation required in a taxable transaction within five years of the distribution. §355(a)(3).

volved in a spin-off.

In the case of split-ups or split-offs, the boot provisions impose a tax, as in other reorganizations, limited to the gain, if any, realized on the transaction. In the case of a spin-off, however, the value of the boot is taxed as a dividend if the company has sufficient accumulated and current earnings to cover the boot distribution.[45] The amount taxed as a dividend is not limited by the gain realized by the shareholder and is not limited by the shareholder's ratable share of corporate earnings.[46]

The difference in tax treatment is unrealistic. Although different pieces of paper are held by stockholders at the conclusion of a transaction, depending upon whether the transaction is a split-up, split-off or spin-off, the economic results are the same regardless of the form the transaction takes. Obviously, boot distributions in divisive reorganizations should not be made until the tax consequences of casting the transaction in the form of an exchange, either split-off or split-up, or no exchange, spin-off, have been examined.

VIII. Boot Received On Transfers To Controlled Corporations

Section 351 permits a tax-free transfer of property to a newly organized or existing corporation if the transferors of the property are in control of the corporation after the transfer. The boot provisions are applicable if the transferors receive something other than stock or securities of the corporation to which the property is transferred. If boot is received it will be taxed as a gain on the sale of property. No part of the gain is taxable as a dividend. If the corporation takes property subject to liabilities or as-

45 §356(b).

46 Corporate earnings for this purpose include the current year's earnings as well as accumulated earnings.

sumes liabilities of the transferors of property to it, the liabilities are ordinarily not treated as boot.[47]

However, if the amount of liabilities to which the property transferred is subject, plus the amount of liabilities assumed, is in excess of the basis for the assets transferred to the company, then the excess is treated as a gain from the sale of property.[48] If mixed assets are transferred, the gain is allocated to all the assets on the basis of their fair market values.[49]

IX. When Will Reorganization Be Disregarded?

As seen above, a transaction qualifying as a reorganization is tax-free unless items subject to the boot provisions are also distributed. The taxable gain is limited to the

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47 §357 provides that the assumption of liabilities or the transfer of property subject to liabilities shall not be treated as boot on a §351 exchange unless the principal purpose of the transaction was the avoidance of income tax, or the transaction was entered into for a bona fide business purpose.

48 §357(c).

49 U.S. Treas. Reg. §1.357(1955). The allocation of gain to assets on the basis of their fair market values can lead to harsh results. Assume that A transfers the following assets to a controlled corporation:

	Tax Basis	Market Value
Land and Buildings	$ 5,000	$ 50,000
Securities	25,000	25,000
Inventories	25,000	25,000
	$55,000	$100,000

The land and buildings is a capital asset held for over six months and it is transferred subject to a mortgage of $40,000. The securities are also capital assets in his hands which he has owned for two months. The inventories are business assets.

The controlled corporation assumes a liability of $25,000 owed by A so that A has a gain of $10,000 on the transaction: the difference between $65,000, the total liabilities assumed, ($25,000 plus $40,000) and $55,000, the aggregate basis of assets transferred. The gain will be allocated and taxed as realized on the assets transferred to the company on the basis of their market values, resulting in $5,000 long term capital gain on the land and building, $2,500 short term gain on the securities, and $2,500 ordinary income on the inventories.

The entire gain of $10,000 is attributable to the land and buildings and consequently should be taxed as a long term capital gain. This result would be achieved if A sold the securities and inventories and contributed $50,000 in cash to the company.

value of the boot received. The reorganization sections are a shelter against the imposition of an immediate tax and the boot provisions, in some cases, limit the amount otherwise taxable.[50]

The *Adams* and *Bazley* cases[51] are a warning that mere compliance with the technical requirements of the reorganization sections is not sufficient to invoke the protective features of the boot sections unless there is a valid business purpose for the proposed transaction. A tax advantage to be gained by stockholders, standing alone, is not sufficient to justify the application of the provisions.[52]

X. Section 306 Stock Recei-ed On A Reorganization

The boot provisions of the Code are designed to tax immediate gain realized on an exchange involving the receipt of something more than stock or securities. The 1954 Code added provisions designed to impede preferred stock bail-outs effected through tax-free reorganizations which are not subject to the boot provisions. These provisions are contained in section 306. They differ from the boot provisions in that the receipt of section 306 stock does not result in an immediate tax. The tax is deferred until there is a disposition of the stock. The proceeds realized on a redemption or sale of the stock may be treated as dividend income.

50 U.S. Treas. Reg. §1.301(e) (1955) provides that a distribution connected with a reorganization may nevertheless be taxable as a dividend if it is in substance a separate transaction.

51 331 U.S. 737 (1947) (heard and decided together).

52 This is equally true in the reverse situation. The dissolution of a corporation having liquid and working assets and the reincorporation of the working assets is technically not a reorganization. However, the reorganization and boot provisions nevertheless have been applied to tax gain as dividend income. Liddon v. Commissioner, 230 F.2d 304, (6th Cir. 1956), *cert. denied,* 352 U.S. 824 (1956); Lewis v. Commissioner, 176 F.2d, 646 (1st Cir. 1949).

Preferred stock received in a reorganization is section 306 stock if the effect of the distribution is substantially the same as a stock dividend or if it is issued with respect to section 306 stock.[53]

The regulations provide that preferred stock received on a reorganization will be treated as section 306 stock to the extent that a cash distribution in lieu of such stock would have been a dividend under the boot provisions.[54] Taken literally, this seems to mean that a stockholder having a loss in a reorganization involving boot would not receive section 306 stock. A stockholder having gain would receive section 306 stock only to the extent of his gain.

XI. Conclusion

The tax treatment of boot is, on the whole, governed by fairly well established rules.

The recent *Howard* case has reopened the basic question of whether a boot distribution destroys a tax-free acquisition of control by an acquiring corporation since the statutory definition of this type of reorganization provides for an exchange "solely" for voting stock. It is refreshing to find a court following a liberal construction of the 1939 Code in favor of the taxpayer, but it may be overly optimistic to expect that the *Howard* case will be followed by other courts, including the Supreme Court, in view of the statutory provisions and previous decisions which applied the definition literally.

The *Northup* case may be the beginning of a judicial re-examination of the rules which determine the extent to which boot is subject to dividend treatment. *Northup* soundly declined to apply dividend treatment to a redemption of preferred stock since the redemption did not pro-

53 §306(c)(1)(B).

54 U.S. Treas. Reg. §1.306-3(d) (1955).

duce the same effect as the declaration of a cash dividend. The rule should have equal force as a standard for determining the limits of dividend treatment on boot distributions.

Debentures issued in exchange for stock in a reorganization are taxable as boot under the 1954 Code. The innovation will undoubtedly restrict the use of debentures in reorganizations. However, if stockholders are permitted an option as to the type of securities which they may elect to receive on an exchange in a reorganization, some of the disadvantages of the boot treatment of debentures will be obviated.

The treatment of boot received in a divisive reorganization is illogical and the 1954 Code should be amended to provide for uniform treatment of boot received in all types of divisive reorganizations.

As illustrated above, precise conclusions cannot, as yet, be stated in some fringe areas of the boot taxation question. Problems connected with dividend treatment of boot under the 1939 Code were not completely resolved by the judicial process. The problems continue under the 1954 Code in aggravated form due to the expansion of the definition of boot and the introduction of section 306 stock. Consequently, caution should be exercised before distributing boot unless the transaction falls within the established and defined rules.

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