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CORPORATE DISTRIBUTIONS AND ADJUSTMENTS — SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954

The quest for certainty in taxes — except in the doleful sense of their inevitability — is never-ending. Too often, however, when, in the effort to achieve certainty, mechanical rules are substituted for judgment, taxpayers find themselves on the wrong side of the arbitrary lines which must be drawn. When this happens, taxpayer preference for the type of flexibility which permits cases to be decided on their merits revives and the old order is thought to be not so bad after all. This in essence is the story of the 1954 revision of the provisions dealing with corporate distributions and adjustments. In other words, the abrupt retreat from the House version of the Bill was motivated by a mixture of reluctance to abandon the familiar and the realization, brought about by particularization, of the price that must be paid for rules of thumb.

For convenience, the subject of corporations, their shareholders, and the relations between them may be divided into three parts, as has been done in subchapter C

of Chapter 1 of the new Code, leaving out of account insolvency reorganizations and carryovers. The first deals with corporate distributions other than in liquidation, the second with corporate liquidations, and the third with corporate organizations and reorganizations. The basic structure of the statutory scheme has long been relatively simple. A corporation is not a mere extension of its shareholders' personalities, but is a separate entity, taxable on its own income. Shareholders are not taxable on such income until it is distributed to them, at which time it constitutes income on the shareholders' investment, that is, dividends, taxable at full rates.[1] If, on the other hand, the shareholders dispose of their investment, the resulting gain, if any, even though it may be represented in whole or in part by accumulated earnings of the corporation, which, if distributed in ordinary course, would be taxed as dividends, is taxed at capital gains rates. Such a disposition can take the form of a sale to third parties or a sale to the corporation. For this purpose, the receipt of a liquidating distribution is treated as a species of sale to the corporation.

Strict adherence to the logic of the corporation as a separate entity would produce many taxable events which as a practical matter it may be better to ignore. Suppose an inventor and his backers decide the best way to exploit his invention is to organize a corporation for the purpose, the inventor transferring his invention and his backers paying in cash in exchange for all the corporation's stock. Despite the fact that the stock received by the inventor may be worth more than his investment in, though not the value of, his patent and that he may therefore technically realize gain, Congress has long thought that this is an inappropriate time to cast accounts for tax purposes. Similarly, if a business already in corporate form is re-

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[1] We are speaking here conceptually and therefore leave out of account the dividend exclusion, the dividend received credit, and, in the case of corporate shareholders, the dividend received deduction.

organized, either by way of recapitalization, or through migration of the corporate charter, or by merger or consolidation, the shareholder retaining a continuing interest in the business as such, some rule for non-recognition of the technical gain realized in such cases must be provided if for no other reason than the practical one of not placing an embargo on normal and often economically desirable business transactions. This is not to say that the motivation for such non-recognition provisions may not also be in part conceptual, *i.e.,* that in some contexts a corporation is more a matter of form than of substance, but so many neuroses have developed concerning the use and abuse of these provisions over the years that the point has almost been reached where, in order to be fully understood, they must be read in the light of what they are intended to prevent as much as in the light of what they are intended to permit.

I

CORPORATE DISTRIBUTIONS

The simple corporate distribution is one made in cash and without any pretense of redeeming any stock. If the corporation has earnings and profits of the taxable year, or accumulated since March 1, 1913, in an amount at least equal to the distribution, it is taxable to the recipient shareholders as a dividend. To the extent that the earnings and profits are not sufficient to cover the distribution, it is treated as a capital recovery until it equals the taxpayer's investment in the stock; any excess (except when it comes out of pre-March 1, 1913, appreciation in the value of property, which is distributable tax-free) is treated as a gain from the sale of the stock. On these basic principles the old law and the new are alike.

Complications arise when the distribution is not in money, but in property. Under the old law the general rule

was that property distributions were to be picked up by the distributees at fair market value. Passing for the moment the questions of dividend measurement where earnings and profits were sufficient to cover the distributing corporation's basis, but not the fair market value, of the distributed property and of the effect of such a distribution on the distributing corporation's earnings and profits account, this rule often made the intercorporate dividend route a cheap device for stepping up the basis of appreciated property. Starting with the premise that a distributing corporation realizes no gain from the distribution of an appreciated asset in kind and taking into account the fact that a corporate recipient pays tax on only 15 percent of dividends received from another domestic corporation, an asset costing $10,000 but worth $100,000, for example, could be distributed to another corporation as a dividend without increasing the distributee's income by more than $15,000 (15 percent of $100,000). But the property would be deemed to have "cost" it $100,000, since that was its value upon receipt; such "cost" would be available to the distributee corporation to measure future depreciation, or gain or loss on future disposition. There would never be a corporate tax on the $90,000 of appreciation as such.

Such was the state of the law until the Revenue Act of 1950. Section 122[2] of that Act adopted the drastic remedy of limiting the dividends received credit of a corporate shareholder upon the receipt of appreciated property as a dividend in kind to 85 percent of the basis of such property in the distributing corporation's hands. Thus, in the example given, the shareholder corporation would be taxable on $91,500 as ordinary income ($100,000, the fair market value of the property, less a dividends received credit of $8,500). Where the gain, if realized by the distributing corporation itself, would have been capital

[2] Revenue Act of 1950, § 122, 64 STAT. 919-20, (1950).

gain, the solution was an unduly harsh one. By focusing on the dividend rather than the primary corporate tax on the appreciation itself, it was a violation of the general scheme of corporate taxation. But drastic as it was, the solution did not cover cases where, because of the absence of earnings and profits, the distribution would not be a dividend, but would simply be applied against the basis of the stock.

Taking a new look at the problem, the draftsmen of the 1954 Code decided that the best answer was to limit the amount of the distribution in such cases to the basis of the property in the hands of the distributing corporation. Therefore, the corporate recipient would be deemed to have received a distribution of only $10,000; if it was a dividend, the amount subject to tax would be only $1,500; the $10,000 basis of the property in the hands of the distributing corporation would carry over to the distributee corporation; and the $90,000 of appreciation would not be taken into account until actually realized at the corporate level in some subsequent transaction.

At least two interpretative problems can arise under this new structure, taken together with the definition of property in Section 317 (a)[3] and the stock dividend rules of Section 305. Assume an intercorporate dividend in bonds of the distributing company, issued at an interest rate which makes them immediately salable at a premium. Or assume a taxable stock dividend (in payment of current preference dividends, for example) in newly issued shares worth $100 each. Both are apparently to be treated as property distributions, the first because Section 317 (a) states that:

> For purposes of this part, the term "property" means money, securities, and any other property; except that

[3] Throughout the remainder of the article, references to sections by number are to the INTERNAL REVENUE CODE of 1954 unless otherwise specifically stated in the text or indicated by footnote.

> such term does not include stock in the corporation making the distribution (or rights to acquire such stock),[4]

and the second because, despite the exception in Section 317 (a) concerning stock of the distributing corporation, Section 305 (b) provides that a so-called taxable stock dividend:

> . . . shall be treated as a distribution of property to which section 301 applies—. . .[5]

How is the adjusted basis rule to be applied? Perhaps the answer is that the rule operates only where the property distributed has a basis (even though it may be zero) in the hands of the distributing corporation and not where it has no basis at all because from the distributing corporation's point of view it is not an asset, but a liability. This is fortified by the fact that the rationale of the adjusted basis rule has no operation in either a stock or a bond case. There is no appreciation in the hands of the distributing corporation to be preserved for future recognition. Thus, one part of the comparison being missing, we are forced in all cases to resort to the other, *viz.,* fair market value. Of course, the necessity of resorting to this or other makeshift arguments, such as that the basis of a bond is face since that is the measure of the liability and is also the amount by which earnings and profits are reduced (see Section 312 (a) (2)), is unfortunate, and the ambiguity ought to be corrected by legislation.[6]

Another apparent oversight is Section 453 (d), which will tax the distributing corporation on the distribution of an instalment obligation. Under the adjusted basis rule of Section 301 (b) (1) (B) (ii) and (d) (2) (B) it is provided that both the intercorporate distribution and the

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4 68A STAT. 99 (1954).

5 68A STAT. 90 (1954).

6 Section 1.301-1(d) of the Treasury's proposed regulations takes the position outlined in this paragraph.

carryover basis shall be increased by the amount of gain recognized to the distributing corporation under Section 311 (b) and (c), dealing with the distribution of LIFO inventories and assumption of liabilities, respectively. For some reason there is a failure to specify that adjustment should also be made for the gain recognized under Section 453 (d) on the distribution of an instalment obligation; this failure is all the more surprising since Section 311 (a) itself refers to Section 453 (d) as an exception to the general rule of non-recognition of gain or loss to the distributing corporation upon a property distribution. Unless this is corrected there is a danger of two full taxes in this situation, one to the distributing corporation on the distribution and one to the distributee corporation when it realizes on the obligation. With the inequity so patent and the general principle of the statute so plain, perhaps there is a chance the letter of the law will not be applied — a technical excuse may be found in the subtle differences which exist in the instalment provisions of the Code as compared with other non-recognition provisions turning on preservation of basis; but the reed is a slender one to lean upon in view of the apparent applicability of the maxim *inclusio unius exclusio alterius.*

Property distributions in the past have produced other complications. Let us assume a non-corporate shareholder, to whom the adjusted basis rule just discussed is not available and by whom, therefore, all property distributions are reportable at fair market value. Let us further assume that he is the sole shareholder of his corporation, which distributes to him property having a basis in its hands of $25,000, but a fair market value of $100,000, at a time when its earnings and profits account stands at only $40,000. How much is taxable as a dividend, and by how much should the corporation's earnings and profits account be reduced?

Turning to the old Code, we find, first, a definition of

the term "dividend" (section 115 (a))[7] substantially similar to that contained in Section 316 (a) of the new Code:

> . . . any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of earnings or profits of the taxable year. . . .[8]

No quantitative definition of a distribution was provided, however. In lieu thereof, Section 115 (j) provided:

> If the whole or any part of a dividend is paid . . . in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.[9]

With this statutory framework, it was at least arguable that a dual approach to the question of quantum was possible, one for the purpose of determining the character of the distribution, that is to say, the extent to which it came out of earnings or profits, and the other for the purpose of determining the dollar amount to be reported by the shareholders. Translating this in terms of our example, we would say that, from the distributing corporation's point of view, the distribution is $25,000, that being the figure assigned to the property in stating the corporate accounts, including the amount of its earnings and profits. Since this is less than the amount of the earnings and profits account, the entire distribution is out of earnings and profits and therefore a dividend. From this point on everything is clear: Section 115 (j)[10] requires the shareholders to report $100,000.

The income tax is over 40 years old, but this answer to a vexing problem was not reached until May of 1954, when two Courts of Appeals came to the same conclusion

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7 INT. REV. CODE of 1939 § 115 (a).

8 *Ibid.*

9 INT. REV. CODE of 1939 § 115 (j).

10 *Ibid.*

simultaneously.[11] Prior to these decisions, it appeared that, after many years of battling in the courts, the Commissioner, barring legislation, would be forced to accept a single-standard approach to the measurement of dividend income. That is to say, both for the purpose of determining whether it was out of earnings and profits and for the purpose of measuring the shareholder's includable amount, a property distribution would be taken into account at fair market value. In terms of our example, this would mean a dividend of only $40,000. In other words, the corporation would be considered to have made a distribution of $100,000, but since it had only $40,000 of earnings and profits, only that amount is considered as out of earnings and profits and therefore a dividend. The remainder would be a return of capital — presumably the shareholder's capital, since the unrealized appreciation did not appear anywhere in the corporation's balance sheet, either as capital or surplus.

During the course of this controversy over the years, various other approaches were likewise attempted. One was to argue that, though unrealized appreciation was not includable in income,[12] it was includable in earnings and profits for purposes of dividend measurement, thereby producing the necessary basis for holding the distribution to be a dividend. To revert again to our example, the corporation's earnings and profits account would be increased to $115,000 ($40,000 plus $75,000), which would be ample to cover the $100,000 distribution. Little or no success was had with this approach in the courts. Essentially, the Government preferred it to matching basis against earnings and profits computed without reference to the appreciation in the asset distributed, since it might produce a

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11 Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954), *cert. denied,* 75 Sup. Ct. 85 (1954); Commissioner v. Godley, 213 F.2d 529 (3d Cir. 1954), *cert. denied,* 75 Sup. Ct. 86 (1954).

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

greater dividend in cases of no earnings and profits or earnings and profits less than basis.

Variations of the basis technique have also been advanced. One represents the only type of situation in which the Commissioner met with success prior to 1954. One or two decisions[13] suggested that if the distributed property was acquired out of earnings and profits, then any appreciation in its value would likewise be in the nature of earnings and profits. No one was happy with such a rule, however — tracing was out of the question; and these cases must be regarded as sports.

Still another variation of the basis measure involves a backhanded approach to the out-of-earnings-and-profits test, that is to say, reading it to mean "not out of capital." This is an adaptation of the partial liquidation rule set forth in old Section 115 (c) to the effect that the part of a distribution in partial liquidation:

> . . . which is properly chargeable to capital account shall not be considered a distribution of earnings or profits.[14]

In other words, the part which is not properly chargeable to capital account shall be considered a distribution of earnings and profits. Since only the basis of the asset is reflected in the corporate accounts, so the argument runs, no more than the basis can ever be attributed to capital, even if there are no earnings and profits. Therefore, unrealized appreciation must always be considered as out of earnings and profits. This argument is mentioned in the *Hirshon* case, though not necessarily a part of the *ratio decidendi*, since the basis itself was amply covered by earnings and profits.

Because of the relative simplicity of their factual situations (earnings and profits at least equal to basis), even

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13 Commissioner v. Wakefield, 139 F.2d 280 (6th Cir. 1943); Binzel v. Commissioner, 75 F.2d 989 (2d Cir. 1935).

14 INT. REV. CODE of 1939 § 115(c).

Hirshon and *Godley* left many troublesome questions unanswered. What happens when the basis of the distributed property is only partly covered by earnings and profits, or not at all? Will a percentage test be applied? Or will one of the alternate methods of bringing unrealized appreciation into account be employed?

Curiously enough, when the draftsmen tackled this problem in drawing up the House version of the Bill, it was assumed that the law as to taxability of the recipients of a property distribution had been settled by decision against the Government's contention that unrealized appreciation could be taxed as a dividend in the absence of regularly computed earnings and profits sufficient to cover it and that the only problem, except to the extent that it was determined as a matter of policy to change the law, was as to how the earnings and profits account ought to be charged in the case of such a distribution. Should earnings and profits be charged by fair market value or by basis? Prior law was uncertain. Section 310(a) of the House Bill—Section 312(a) in the Code as finally enacted—properly provided that the reduction should be by basis, whether the property had increased or decreased in value.

The supposed general rule that dividend measurement was to be based on a comparison of regularly computed earnings and profits and fair market value of the distributed property was left alone, however, except where the distributed property was inventory. In inventory cases unrealized appreciation is to be added to earnings and profits, making it taxable to the shareholders as a dividend, and a corresponding reduction made as a result of the distribution.[15]

Then came *Hirshon* and *Godley,* indicating that the as-

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[15] This rule should probably contain an exception relative to intercorporate distributions, where basis is a limiting factor in measuring the distribution. Unrealized appreciation ought not to be permitted to convert a distribution measured by basis into a dividend.

sumption that the character of the distribution was to be determined under the old law by looking at fair market value rather than basis was erroneous. This confronted the policy-makers with a difficult problem: What should be done with the Government's hard-won victory? Should it be gratefully accepted, with or without some further spelling-out in the statute to clarify the ambiguous situations which have already been mentioned? Or should the Bill stand pat on what had already been decided in framing the House version? The answer was apparently to stand pat, with a cautionary word in the Senate Committee Report that, in view of the intervention of *Hirshon* and *Godley,* the Committee:

> . . . does not intend any implication from the enactment of section 312 (a) with respect to the effects of a distribution of property on earnings and profits and on the shareholders under the 1939 Code.[16]

Since the supposed result under the House Bill was not written in so many words across the face of the statute and was based to some extent at least on an erroneous assumption of what the prior law was, and since the language of the Bill was not actually changed as a result of *Hirshon* and *Godley,* the question may arise as to whether the rule does not fall with the assumption. Superficially this may appear to be a tenable position, but on closer inspection it is believed that the argument must fail. First and foremost is the inference to be drawn from the spelling-out of the rule as to inventories: since it is specified that unrealized appreciation *is* to be added to earnings and profits in the case of distributions of inventories, the statute must be interpreted to mean that unrealized appreciation is *not* to be added to earnings and profits in other cases. This argument is further supported by the observation that the charge-off rule in non-inventory cases does not contemplate such an addition, for the

16 SEN. REP. No. 1622, 83d Cong., 2d Sess. 248 (1954).

reduction in earnings and profits by reason of the distribution in such cases is limited to the basis of the property distributed. If in answer to this argument it is contended that, though the inclusion-in-earnings approach may be precluded, the basis technique of the *Hirshon* and *Godley* cases is not ruled out, the further point can be made that, intentionally or unintentionally, the quantitative definition in terms of fair market value, which formerly applied to the dividend after its character as such had been independently determined, has now been shifted to the distribution itself. Section 301 provides in part as follows:

> (a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).
>
> (b) AMOUNT DISTRIBUTED.—
>
> (1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be —
>
> (A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.
>
> • • •
>
> (c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies —
>
> (1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.[17]

Section 316 (a), in turn, provides in part as follows:

> For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders —[18]

out of its earnings and profits. Perhaps the inclusion of the phrase "for purposes of this section" in Section 301 (b) (1), coupled with the rule of Section 312 (a) that the earnings and profits are to be reduced only by the basis of the distributed property, prevents this definitional

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[17] 68A STAT. 84-5 (1954).

[18] 68A STAT. 98 (1954).

argument from being entirely conclusive, but the Government's case is certainly weaker for a dual test than under the 1939 Code. Of even greater importance than the argument based on change of definition, however, is the fact that Section 312 (b), which lays down the inventory rule, makes no sense except against the background of a general assumption that in determining dividend status the fair market value, rather than merely basis, of distributed property must be measured against earnings and profits. The purpose of adding appreciation to earnings and profits is to make sure that in inventory cases there will be enough earnings and profits to take care of appreciation, under a system of looking at full fair market value at the distribution as well as the receiving level. Section 312 (b) varies the result, not the system, in a special class of cases. Utterly absurd consequences would flow from assuming the system under which Section 312 (b) is to operate to be that laid down in *Hirshon* and *Godley*. Finally, the endorsement in the Senate Report of the House Report examples, which spelled out the fair-market-value rule, is unambiguous evidence of the Congressional intent. It is obvious that the rule which, in the House Bill, was viewed as merely a clarification of existing law, is intended to be continued even though it may ultimately be shown to constitute a change in existing law. As a technical matter, this may be said to involve a determination of what the House rule was, in the process of which *Hirshon* and *Godley* would not be irrelevant, but this would be a species of renvoi reasoning in conflict with the realities of the whole record.

Whether this is what the law ought to be is another question. Earnings and profits equal to the full fair market value of the asset distributed are apparently necessary in order for the distribution to be "out of earnings and profits" and therefore a dividend. After the distribution, however, only so much of the earnings and profits as

equals basis is regarded as having been distributed. Why should the extra earnings and profits be required in the first place? They are no more than a magic word the utterance or non-utterance of which ought scarcely to have tax consequences. Despite the logical nicety of the basis approach, on the other hand, it too has its unrealities. The fact is that property worth much more than its basis in the corporation's hands is being distributed; yet, the appreciation is a neutral factor in determining the result and everything turns on how basis compares with earnings and profits. If we wish dividend consequences, the approach which adds appreciation to earnings and profits, as is done in the case of inventories, appears to be the more appropriate. Arguably, it should be enough that the corporation escapes tax, without adding to it by giving the shareholders different treatment from that which would result if the corporation had realized its gain and distributed the proceeds. Only the inventory approach will accomplish this, not the technique of making the nature of the distribution to the shareholders turn on the accidental factor of the amount of earnings and profits computed without reference to the appreciation, — accidental because, by our charge-off rule, we admit it really has nothing to do with the case. At the same time, practical considerations may be worth more than logic in this field. In theory a case could perhaps be made for foregoing dividend consequences in all cases of unrealized appreciation not involving stock in trade, as a kind of extension of the so-called anti-*Court-Holding-Company* rule[19] to the field of distributions, but there are few who would be willing to go this far and the lines which have been, or which were intended to be, drawn in the new Code[20] may

19 Section 337, designed to overrule Commissioner v. Court Holding Co., 324 U.S. 331 (1945).

20 See, also, the special rule on distributions of proceeds of loans insured by the United States, contained in Section 312 (j).

be a fair compromise.[21]

While the questions thus far discussed are intellectually of great interest, the major problems in the field of corporate distributions are those dealing with the efforts of shareholders to realize what is essentially dividend income in the form of capital gains. Much human ingenuity has been spent in this direction with, from the standpoint of the Internal Revenue Service, all too frequent success. Taxpayers have also complained that, under the amorphous rules of the law prior to the 1954 Code, excessive zeal on the part of the Government caused some transactions which were genuine capital transactions to be treated as the equivalent of dividend distributions. Therefore, both sides sought clarification. In addition, it was admitted that a recent decision had put taxpayers so far ahead in the preferred-stock bail-out game that legislation was needed to keep it from becoming a rout.

The broad distinction between the sale of stock, on the one hand, and the receipt of dividends on such stock, on the other, is clear enough in the simple case. Even when liquidating or redemption cases are included in the sale category our sense of logic is not disturbed. But suppose a corporation, instead of paying a cash dividend, distributes a non-taxable stock dividend in the form, say, of preferred stock, which it thereafter promptly "purchases", *i.e.*, redeems, from its shareholders. Obviously capital gains treatment ought not to be available in such a case, and it was ruled out as far back as 1921,[22] but only, be it noted, where the issuance and the redemption were part of a plan the effect of which was to make the redemption the equivalent of a dividend. Suppose, then, that the

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[21] Since the preparation of this analysis, the Treasury has released proposed regulations under subchapter C, section 1.316-1(a)(3) of which takes the position that Hirshon and Godley continue to be the law under the 1954 Code.

[22] Section 201 (d), Revenue Act of 1921, 42 STAT. 228-9 (1921).

transaction is reversed, and stock is first redeemed and then replaced by the issuance of a non-taxable stock dividend. Again the answer is obvious, but it took another revenue act to reach it.[23] Finally it became clear that a redemption of stock might well be the equivalent of a dividend even though entirely unconnected with a stock dividend. Suppose A owns all the stock of the X Corporation, which he organized for $100,000 in cash. The X Corporation has prospered and now has $50,000 of earnings and profits, which it desires to distribute to A. In an effort to avoid exposing A to tax on a dividend of $50,000, it "buys" one-third of his stock for $50,000. This in no way affects A's ownership or control of the corporation, for he will still hold 100 percent of its stock. Should he be permitted to say that, instead of a $50,000 dividend, all he has received is a $16,667 capital gain? Every income tax law since the Revenue Act of 1926[24] has said no, but in very general terms, as follows (Section 115 (g) (1) of the Internal Revenue Code of 1939):

> (g) Redemption of stock.
>
> (1) In general. If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."[25]

Every case is not so simple as that between A and his corporation. At the opposite extreme is the case where A is merely one of many unrelated shareholders who has

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[23] Section 201 (f), Revenue Act of 1924, 43 STAT. 255 (1924).

[24] Section 201 (g), Revenue Act of 1926, 44 STAT 11 (1926).

[25] INT. REV. CODE of 1939 § 115 (g) (1). Paragraphs (2) and (3) deal with redemptions through use of subsidiary corporation and redemptions to pay death taxes, respectively, covered in the 1954 Code by Sections 303 and 304.

all his stock redeemed and thereafter has no interest in the corporation. Clearly the redemption of his stock is not the equivalent of a dividend. It is the cases in between that have presented the problem.

As a result of one Supreme Court decision involving a related problem under the reorganization provisions,[26] it was once suggested that Section 115 (g) was applicable in any case to the extent of the corporation's earnings and profits. But this certainly could not be, or Congress would have said so instead of employing the language it did. Moreover, such an approach would catch the complete buy-out case, which everyone agrees is a sale and nothing but a sale. The true test is whether the shareholder's proprietary interest in the corporation as a result of the redemption has been substantially altered. If it has, then the shareholder has parted with something and sale treatment is indicated. If it has not, then what the shareholder has received is in the nature of a dividend. The existence of earnings and profits is, of course, a further requirement in order for a dividend tax to arise. And it should be observed that under Section 115 (g)[27] the dual test of source, *i.e.*, earnings and profits of the taxable year *or* accumulated earnings and profits, is not used; only accumulated earnings and profits are of significance.[28]

The foregoing leaves out of account the concept of corporate liquidation and the bearing which, rightly or wrongly, it may have on the treatment of stock redemptions. Section 115 (c) of prior law provided in part as follows:

> . . . amounts distributed in partial liquidation of a

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26 Commissioner v. Estate of Bedford, 325 U.S. 283 (1945).

27 INT. REV. CODE of 1939.

28 Vesper Co. v. Commissioner, 131 F.2d 200 (8th Cir. 1942), is to the contrary, but this involved a special situation under the undistributed profits tax. The Internal Revenue Service has in general either regarded the phrase "earnings of profits accumulated after February 28, 1913" as controlling or determined that dividend equivalence did not exist where there were no accumulated earnings and profits.

> corporation shall be treated as in part or full payment in exchange for the stock.[29]

It is not an unnatural feeling that a distribution which represents a liquidation of the corporate business is not a dividend equivalent. The shareholder gives the appearance of cashing in on a part of his investment when the business itself is being contracted. And so, somewhat haltingly, the cases have gone. But there is a strong body of opinion which rejects the relevance of the partial liquidation approach, on the ground that the effect upon the shareholder is the only thing that counts when the problem is how the shareholder should be taxed. If the shareholder is still in the same relative proprietary position as before and the amount distributed is not in excess of the corporation's earnings and profits, the fact that such earnings and profits have previously been invested in the business and that their withdrawal from the business and distribution to the shareholders works a reduction in the size or scope of the corporation's activities as they were constituted immediately prior to the distribution should not alter the fact that the shareholder has received a distribution of profits and has not liquidated a part of his investment. It is further argued that the irrelevancy of looking at the effect upon the corporation persists whether the partial liquidation of its business is voluntary or involuntary, whether what is being wound up is a separate business as compared with the continuing activities of the company, whether it was acquired or developed out of accumulated earnings or constituted part of the corporation's original business, and regardless of the fact that two corporations might have been formed to start with, in which case the winding up of either would have been a complete liquidation taxable at capital gain rates.[30]

29 INT. REV. CODE of 1939 § 115(c).

30 Cohen, Surrey, Tarleau and Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COL. L. REV. 1 (1952).

Both approaches are preserved in the 1954 revision, though they are now separately stated as opposed to being merged and indistinct as under prior law. In the House Bill an effort was made to get away from the exercise of judgment involved in any general test of equivalence or non-equivalence to a dividend and to substitute purely mechanical tests in both areas. Thus, looked at from the shareholders' point of view, stock redemptions were treated as sale transactions rather than distributions only if they completely terminated the particular shareholder's interest in the corporation, or if they were substantially disproportionate in the sense of reducing the shareholder's percentage of ownership of participating stock by more than 20 percent, or if the shareholder owned less than one percent of the corporation's participating stock, or, under limitations, if the redemption was to pay death taxes. Rules of constructive ownership were also provided to prevent manipulation within family groups, or through the use of trusts, partnerships, corporate holding companies, etc. The partial liquidation approach was handled by an exclusive definition of the term as meaning a distribution by a corporation in redemption of a part of its stock pursuant to a plan, provided that the distribution occurred within the taxable year of adoption of the plan or the following taxable year and was attributable to the complete termination of one of at least two operating businesses, separately conducted and bookkept for at least five years and no more than 10 percent of the income of which in any year of such five-year period was personal holding company income.

Immediate dissatisfaction was expressed with the "clarification" thus proposed, mainly because it made clearly taxable as dividends many redemptions which it was felt ought not to be so treated. All preferred stock redemptions

would be so treated, for example, to the extent such stock was held by persons owning one percent or more of the corporation's common stock, unless accompanied by a disproportionate redemption of the common stock in their hands or the redemption qualified as a distribution in partial liquidation. The rules of constructive ownership made such a blanket approach all the more questionable and also increased the indigestibility of making mathematically determined disproportionateness the sole test of non-equivalence to a dividend. On the partial liquidation side, great concern was felt over the extreme narrowness of the definition. While the presence or absence of separate books and records might be evidentiary, it ought not to be conclusive. The personal holding company income test was regarded as unrealistic at the percentage levels set forth in the Bill. Finally, it was argued that cases involving contraction of a single business ought also to be covered.

Basically the Senate revision, which became the final version, converted what were exclusive definitions under the House Bill into rules which, if complied with, would establish non-dividend treatment without further argument and added a judgment area of equivalence or non-equivalence to a dividend. The bifurcation set forth in the House Bill was preserved, with the equivalence or non-equivalence test appearing in both branches, though it was intended to have a different meaning in each of its two contexts. At the same time there was some revision in detail of the mechanical rules themselves.

Section 302, which deals with distributions in redemption of stock, tested from the shareholder's point of view, begins by according sale treatment to any redemption which is not essentially equivalent to a dividend. So far as it goes, this appears to leave the law where it was under old Section 115(g),[31] except for the gloss added by the

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[31] INT. REV. CODE of 1939.

Senate Finance Committee Report that equivalence or non-equivalence to a dividend is to be determined without reference to earnings and profits.[32] The question is "whether or not the transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholder to the corporation." The principal result of a determination that redemption is the equivalent of a dividend despite the absence of earnings and profits (presumably on the ground that it is pro rata) is to treat the redemption price as a distribution applicable against the shareholder's entire investment rather than only against his investment in the shares of stock redeemed. While this forms a logical pattern, it seems an unnecessary refinement. Dividend equivalence is a troublesome enough question without enlarging the area of its application to cases where no earnings and profits are present. The taxpayer, having made his bed in such cases, might justifiably be made to lie in it—unless, of course, the whole thing is a subtle way of putting the question of dividend equivalence in its proper setting and avoiding extreme contentions such as are suggested in the *Bedford* case.[33] In any event, it will be a novelty to find taxpayers contending for dividend equivalence. With double the ingenuity formerly employed now brought to bear on both sides of the controversy, the subject of dividend equivalence may henceforth be exhaustively developed as never before.

From this point on, Section 302 goes into particulars. Three specific tests are laid down, compliance with any of which will avoid distribution treatment.[34] One of these, which excludes from the dividend category any redemp-

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32 Of course, a distribution which is equivalent to a dividend is so taxed only to the extent of earnings and profits, but in the new Code current as well as accumulated earnings and profits are taken into account.

33 See Note 26, *supra*.

34 Section 303 adds a fourth: Redemptions to pay death taxes. The subject would also not be complete without reference to Section 304, dealing with redemptions through the use of related corporations.

tion of stock of a railroad corporation issued in a bankruptcy reorganization, is purely arbitrary. The other two are in a sense merely definitions of what is meant by non-equivalence to a dividend, though it is specifically provided that no inferences are to be drawn from failure to meet their terms; that is to say, if the taxpayer qualifies under the specific tests, he is in the clear, but, if he fails so to qualify, he can fall back on the general rule unembarrassed by such failure. The first of these two rules provides for sale rather than dividend treatment in the case of a particular shareholder if the redemption is, as to him, substantially disproportionate, the second if his shareholder interest is entirely terminated. While the latter may appear to be merely an extreme example of the former, they are separately stated since there is a difference between them in the application of the rules as to constructive ownership.

The mathematical formula for determining whether a distribution is substantially disproportionate is, as already suggested, slightly different from that found in the House Bill. To qualify, the taxpayer must after the redemption own less than 50 percent of the combined voting power of all classes of stock entitled to vote and must have had his percentage of ownership both of voting stock and of common stock reduced by more than 20 percent. It is to be observed that it is the taxpayer's percentage of ownership, not the amount of stock he owns, which must be reduced by 20 percent. Thus, if there is only one class of stock outstanding, consisting of 100 shares, of which the taxpayer owns 55, and his is the only stock redeemed, his 55 percent ownership must be reduced to less than 44 percent to qualify. Since the total number of shares outstanding will also be decreased, this means that much more than 11 shares will have to be redeemed. The minimum would have to be 20 shares, leaving him only 35, or 43

plus percent of the 80 shares which would then be outstanding. There is, of course, a policing provision to catch cases where the redemption, though appearing by itself to qualify, is made (Section 302(b) (2) (D)):

> . . . pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.[35]

Provisions like this, while obviously necessary, constitute the wear and tear of the practice of tax law, for there will always be taxpayers who will wish to walk right up to the line without crossing it and who will expect to be advised unequivocally exactly where it is. To revert to the percentage rule itself, questions of valuation may also arise where there is more than one class of common stock, since the 20 percent rule is there applied on a fair market value basis. It goes without saying that there can never be a disproportionate redemption of the stock of a 100 percent shareholder.

On the subject of termination of a shareholder's interest, Section 302(b) (3) states simply that sales treatment shall apply:

> . . . if the redemption is in complete redemption of all the stock of the corporation owned by the shareholder.[36]

The complications are found in the limitations on the rules dealing with constructive ownership as applied to termination cases.

Section 318 lays down rules of constructive stock ownership which are applicable in a variety of situations, including redemption cases. They cover a page and a half of the statute. Briefly, a person is deemed to own stock owned by his parents, spouse, children, and grandchildren.

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35 68A STAT. 86 (1954).

36 *Ibid.*

This is known as the family rule. In addition, stock owned by a partnership, trust, or estate is deemed to be owned proportionately by its members or beneficiaries. If any person owns 50 percent of the stock (by value) of a corporation, any stock owned by that corporation is also attributed to him on a proportionate basis. These partnership, trust, estate, and corporation cases also work in reverse, that is, stock owned by any person to whom stock owned by the entity may be attributed, is deemed owned by the entity, with certain limitations in trust cases to eliminate remote contingent interests. Finally, a person is deemed to own any stock he may have an option to acquire.

These rules are relaxed in only one type of redemption case, *viz.*, where all the stock of the shareholder is redeemed. In such cases the family rule (but only the family rule) is inoperative, if immediately after the redemption the redeeming shareholder has no interest in the corporation (including an interest as an officer, director, or employee) other than as a creditor, he does not acquire any such interest (other than stock acquired by bequest or inheritance) within a period of ten years, and he enters into an agreement with the Secretary or his delegate as to notification and record keeping. Disqualification resulting from a proscribed acquisition within the ten-year period works a reopening of the redemption or any other affected year for purposes of collecting the resulting deficiency. Even the limited relaxation of the family rule is inapplicable when any portion of the stock redeemed was acquired within ten years prior to the redemption from a person whose ownership on the redemption date would be attributable to the taxpayer under any of the constructive ownership rules or the taxpayer transferred stock during such period to any person who owns stock on the redemption date attributable to the taxpayer and the stock so transferred is redeemed in the same transaction,

unless the acquisition in the one case and the transfer in the other can be shown not to have had as one of its principal purposes the avoidance of Federal income tax.

Much of the effect on the redemption problem of this elaborate pattern of attributed ownership remains to be disclosed by experience. Its narrowing effect on the application of the mechanical formula for determining disproportionateness is, of course, obvious. If father and son each own 50 percent of the stock of the X Corporation, for example, there is no way of qualifying under the mechanical formula, for each will be considered as owning 100 percent, and no redemption of the stock of either can reduce him below that percentage. The only course of action in such a case is for one or the other to sever all connection with the corporation. The effect on the more general test of non-equivalence to a dividend is more difficult to measure, as is, indeed, the scope of that test in any of its aspects.

Presumably the main area of operation of the general non-equivalence test lies in the redemption of preferred stock. The basic concept being whether the redemption is pro rata or non pro rata relative to underlying equity interests, some general standards, perhaps varying from case to case depending on intangible considerations difficult to enumerate, will doubtless be applied. If the corporation is publicly held, a much greater tolerance may be permitted than in the case of a closely held corporation. It is possible also that control may be a material factor. To take the extremes, it seems clear that if all the stock of the corporation is owned by a single shareholder, the fact that some of it may be preferred and it is the preferred that is redeemed will not prevent the redemption from being treated as a dividend, whereas, if a shareholder owning only two percent of the equity stock also happens to own two percent of the preferred and only the preferred

owned by him is redeemed, the redemption would not be the equivalent of a dividend. Moreover, in the former case, if the equity stock was all owned equally by father and son, but the preferred by only one of them, the redemption of the preferred would still be a dividend, because of the rules of constructive ownership. An interesting question is whether the pro rata nature of the redemption of preferred stock will be determined on a shareholder-by-shareholder or on an over-all basis. Also to what extent can the general non-equivalence test save a common stock redemption that does not qualify under the mechanical test of disproportionateness? Will a less than 20 percent reduction in percentage of ownership qualify if the shareholder loses control by reason of the redemption? If so, a shareholder would be better off to have had control beforehand than never to have had it at all. Yet, such a shareholder would be parting with an important attribute of ownership as compared with one who was a minority shareholder both before and after the redemption. Perhaps all that can be said at this time is that, with the partial liquidation rules which are about to be discussed available to rescue the non-disproportionate common stock redemption in proper cases and with the apparent purpose for restoring the general non-equivalence test being to cover preferred stock redemptions which would have been unjustifiably caught under the House Bill, any common stock redemption not covered by the mechanical rules of Section 302 should be approached with caution.

If the distribution whereby the stock is redeemed is a distribution in partial liquidation, sales treatment is accorded even though it is completely pro rata. But there is a deceptive similarity in phraseology insofar as basic concepts are concerned to that found in Section 302. In Section 346, which defines the term "partial liquidation," as well as in Section 302, the fundamental approach is that of non-equivalence to a dividend. But, though the

words are the same, the meaning is not. In the one case dividend equivalence turns on whether the redemption distribution is substantially pro rata (or, perhaps, if the loss-of-control point already mentioned has any validity, it would be more accurate to say that the distribution must not alter the distributee's proprietary relationship to the corporation materially); in the other it turns on whether there has been a distribution of earnings and profits as such or a *pro tanto* winding up of the corporation's business.

The definition of partial liquidation is principally an attempt to approach the dividend question from the point of view of the distributing corporation. If the corporation, in the process of closing out a part of its business, makes distributions to its shareholders in redemption of a portion of their stock, the shareholders are regarded as disposing of a part of their investment as opposed to merely drawing down income. Owing to a reluctance to employ the term "contraction of the business" in the statute, however, the seeds of some confusion may perhaps have been sown. The statutory test is that the distribution must be not essentially equivalent to a dividend, must be in redemption of part of the corporation's stock pursuant to a plan, and must occur within the taxable year within which the plan is adopted or the next taxable year. The aids to construction are the Senate Committee Report,[37] which underscores the corporate approach to the test of dividend non-equivalence and states that what is meant is cases of contraction of the corporate business, and the specific rule of Section 346(b) dealing with the termination of one of several businesses.

Under Section 346(b) a distribution shall be treated as a distribution under Section 346(a) (2), that is to say, a distribution in partial liquidation, if it is attributable

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37 SEN. REP. No. 1622, 83d Cong., 2d Sess. (1954).

to the corporation's ceasing to conduct a trade or business and consists of the assets of such trade or business, or the proceeds from their disposition, or both; if such trade or business had been actively conducted for the five preceding years either by the distributing corporation, or by a person from whom or which it was acquired in a completely tax-free transaction, or both; and if another trade or business meeting the same tests as to active conduct is retained by the distributing corporation. On the surface these rules are clear and precise, but in many cases it may be difficult to identify separate trades or businesses and the period for which each has been conducted. To guard against an overtechnical approach the Conference Report states that:

> . . . a trade or business which has been actively conducted throughout the 5-year period described in such sections [355 and 346] will meet the requirements of such sections, even though such trade or business underwent change during such 5-year period, for example, by the addition of new, or the dropping of old, products, changes in production capacity, and the like, provided the changes are not of such a character as to constitute the acquisition of a new or different business.[38]

The reason for the five-year rule being to prevent conversion of cash surplus into a trade or business for the purpose of distribution at capital gain rates, it is hoped that these questions of degree will be decided with an eye to the general atmosphere of the particular case.[39]

One more aspect of the problem of ordinary dividends versus capital gains remains to be discussed, *viz.*, stock

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38 H. R. Rep. No. 2543, 83d Cong., 2d Sess. 38 (1954).

39 Since the preparation of this analysis, proposed regulations under subchapter C have been released, pointing toward a narrower concept of "trade or business" than was anticipated. This is of greater importance in connection with certain reorganization distributions than in connection with partial liquidations, because of the presence in Section 346 of the contraction-of-a-single-business rule as well as that involving liquidation of one of several businesses. Discussion will therefore be reserved until the reorganization sections are reached. See Note 43, *infra*.

dividends. We have already seen that the treatment of certain redemptions as dividend equivalents originated as an attempt to prevent the conversion of ordinary dividends into capital gains by the issuance of non-taxable stock dividends followed by their almost immediate redemption. The redemption problem was soon seen to be far broader than the redemption of stock dividends, however, and the applicable provision was thereupon made to cover redemption of any stock, no matter how issued, finally reaching the state of development which has just been described. At the same time it has gradually become clear that the stock dividend problem extends beyond the redemption area. The acute nature of the problem was pointed up for all to see with the decision, late in 1953, by the Court of Appeals for the Sixth Circuit in *Chamberlin v. Commissioner*.[40] That case involved a large non-taxable stock dividend of preferred on common, which the shareholders had already arranged to sell to an insurance company from which the issuing company was committed to redeem it over a relatively short period of time. Upon sale to the insurance company the shareholders claimed capital gains treatment, stoutly resisting the suggestion of the Commissioner that the whole scheme was merely a device for taking down a cash dividend, with the insurance company acting as a go-between. And the shareholders won.

This decision was regarded as something of a bolt from the blue. Until only the last few years, however, it was not impossible to obtain a ruling and closing agreement from the Treasury on precisely such a transaction. It is difficult to believe that this was owing to lack of sophistication; it must have been from the conviction that it was an inevitable consequence of the non-taxability of stock dividends and that the situation, if it was to be remedied

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40 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954).

at all, would have to be approached directly, *i.e.*, by restricting, to common on common, if possible, the types of stock dividends that could be distributed tax-free. But, whatever the reason, by the time of the 1954 Code, the Treasury was alerted to the demoralizing possibilities of the *Chamberlin* situation. The necessity for doing something about it was all the more pressing, since the new Code was about to extend rather than narrow the area of tax-free stock dividends. In fact, all stock dividends have now been made tax-free by Section 305 of the new Code, except those where the shareholder has the option to take money or other property and those issued in payment of preference dividends for the current or first preceding year.

Apparently on the mistaken belief that it would be inappropriate to impose dividend consequences until money or property was actually paid out by the corporation itself, and perhaps also for ease of administration, the House Bill continued to permit preferred stock received as a non-taxable stock dividend to be sold (as distinguished from redeemed) with the usual privilege of offsetting basis and taxing only the sales profit, almost invariably at capital gains rates. It was provided, however, that, if such stock was redeemed within ten years of its issuance, under circumstances which did not justify treating the redemption as the equivalent of a dividend, except where Section 303, dealing with redemptions to pay death taxes, was applicable, a transfer tax of 85 percent of the amount distributed was to be laid on the distributing corporation.[41] The hue and cry against this provision was instantaneous. Since it covered old issues as well as new, stock issued for property and stock issued in reorganizations as well as stock issued in the form of non-taxable

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[41] This transfer tax also applied to redemption of "non-participating" stock issued for property, if and to the extent it was redeemed for more than 105 percent of the amount received on issuance.

stock dividends, and since, because of the rules of constructive ownership, corporations could not rely on their own records to determine whether they or their shareholders would bear the tax on redemption, and since the ten-year period began afresh on January 1, 1954, in case of previously issued stock, it was alleged that the proposed rule would produce unprecedented hardship and confusion. Even more basic objections were that it reached the wrong person and that it validated rather than repudiated *Chamberlin,* requiring only that the insurance company retain its investment for ten years. Half-hearted attempts to rebut these objections were made, as, for example, by arguing that bail-out cases were usually confined to closely-held corporations where there was an identity of interest between the benefiting shareholders and the corporation and that a ten-year waiting period, with all the restrictions an insurance company would impose, would make the device relatively unattractive (of course, the bailers-out could wait nine years to sell), but these attempts were unconvincing.

The Code as finally enacted adopted the direct approach of going after the original shareholder upon the redemption or first sale of the dividend stock. The operative provision is Section 306 and the type of stock with which it deals, known as Section 306 stock, is defined therein. Section 306 stock consists primarily of preferred stock issued as a non-taxable stock dividend on common stock, but it also includes any kind of stock, common or preferred, issued as a non-taxable stock dividend on preferred stock. From this basic concept, the definition moves on to cover preferred stock received in a reorganization or corporate separation tax-free, if the effect of the transaction is substantially the same as the receipt of a stock dividend or the stock is received in exchange for Section 306 stock. Presumably the test of whether the transaction is the equivalent of a stock dividend is whether an equivalent

cash distribution would have been a dividend at the time the preferred stock was received. Note, however, that in this area common stock can be received in satisfaction of preference dividend rights without being designated Section 306 stock. Finally, if in any other type of transaction the taxpayer has acquired stock the basis of which in his hands is determined with reference to the basis of Section 306 stock, such stock is or continues to be Section 306 stock. This last will cover gift stock which in the hands of the donor was Section 306 stock, stock of a holding company organized to hold Section 306 stock, and Section 306 stock received from a subsidiary in an intercorporate liquidation with a carryover basis.

Supplementary provisions to cover deviations from the norm are next spelled out. Stock rights are to be treated as stock and stock acquired through the exercise of stock rights is treated as distributed at the time of the distribution of the rights to the extent of the fair market value of the rights at such time. Common stock convertible into any other kind of stock or into property is not treated as common stock. Moreover, when the terms and conditions of stock are changed, the date of such change is introduced as an additional point of reference, if it operates to the taxpayer's disadvantage. On the other hand, if Section 306 stock which was issued with respect to common stock is converted back into common stock of the same corporation, the curse of Section 306 is lifted. And an over-all limitation on the operation of the section is provided in the form of excluding from the definition of Section 306 stock any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of such stock.

Now for the tax consequences of the sale or redemption of Section 306 stock. If the cash realization takes the form of a redemption, the entire amount of the redemption price

is treated as an ordinary distribution taxable as a dividend to the extent of available earnings and profits, unless the distribution is a liquidating distribution or unless it is within Section 302(b) (3) already discussed, dealing with complete termination of the shareholder's interest in the corporation. If it takes the form of sale or exchange, so much of the sales price will be taxed as gain from the sale of a non-capital asset as does not exceed the amount that would have been a dividend had money equal to the stock's fair market value been distributed in lieu of the Section 306 stock. The only exception is where the shareholder parts with his entire stock interest, subject to the constructive ownership rules of Section 318(a). In both situations, the general non-recognition provisions of the Code are allowed to operate, so that, to the extent that under such provisions gain or loss to the shareholder is not recognized with respect to the disposition of the Section 306 stock, the taxing provision (though not necessarily the definitional provisions) of Section 306 are inoperative. Section 306 is similarly made inapplicable under the circumstances described in subsection (b) (4):

> (4) TRANSACTIONS NOT IN AVOIDANCE.—If it is established to the satisfaction of the Secretary or his delegate —
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> (A) that the distribution, and the disposition or redemption, or
>
> (B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,
>
> was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.[42]

Some differences between use of the sales route and use of the redemption route for ultimate cash realization in the case of Section 306 stock should be noted. In the

[42] 68A STAT. 91 (1954).

first place, in the case of a sale, the ordinary income consequences are measured by the corporation's earnings and profits at the time of distribution; in the case of redemption, at the time of redemption. In the second place, in the case of a sale, the ordinary income consequences are produced by treating the amount realized "as gain from the sale of property which is not a capital asset"; in the case of redemption, the amount realized is a dividend. The dividend exclusion, the dividend received credit, and, when the shareholder is a corporation, the dividend received deduction apply only where there is a redemption and not where there is a sale. The same differences exist in the case of the foreign tax credit. Also, in termination cases the family rule continues to be fully applicable where a sale, as opposed to a redemption, takes place. Finally, the amount not taxed as ordinary income is applied against only the basis of the Section 306 stock for purposes of computing any further capital gain in sale cases (no loss is ever allowed), but apparently against the basis of all the stock (or at least the stock with respect to which the Section 306 stock was issued) owned by the shareholder in redemption cases. These differences are pointed out, not in criticism, but in warning.

So much for the bail-out problem. Section 306 gives the appearance of being extremely complicated, and, viewed in detail, it is. Nevertheless, with the broad outlines of its policy fixed firmly in mind, the pattern is not too difficult to follow. Lack of omniscience on the part of the framers of the language may have laid unintended traps or left loopholes, but a wise exercise of the Secretary's discretion as to non-avoidance cases should restrict the area of hardship and, as to loopholes, at least it can be said that attempted tax avoidance in the bail-out field has been made extremely hazardous and those opportunities that may have been inadvertently overlooked can be

barred by future legislation as they may come to light.[43]

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[43] The second part of Mr. Peterson's article on Subchapter C of the INTERNAL REVENUE CODE of 1954 is scheduled to appear in the May, 1955 issue of the *Lawyer.*

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