Taxation of Boot Distributions: A Return to Bedford?

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TAXATION OF BOOT DISTRIBUTIONS:
A RETURN TO BEDFORD?

Gain or loss on the sale or exchange of property generally is recognized for federal income tax purposes. However, section 354(a) of the Internal Revenue Code (Code) provides an exception: No gain or loss will be recognized if, pursuant to a plan of reorganization, stock or securities of one corporation are exchanged solely for stock or securities of another corporation that is a party to the reorganization. Not all reorganizations, however, involve an exchange solely of stock or securities. In acquisitive reorganizations shareholders of the acquired corporation also customarily receive cash or other property in exchange for their stock. The receipt of this additional consideration, commonly referred to as “boot,” converts an otherwise tax-free transaction into a partially taxable one: If any gain is realized, it is recognized to the extent of the boot received.

1. I.R.C. § 1001(c) provides: “Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.”

2. I.R.C. § 354(a)(1) provides: “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.”

I.R.C. § 368(a)(1) defines “reorganization” as comprising mergers, consolidations, acquisitions by a corporation of the stock or assets of another corporation, recapitalizations, and changes in identity, form, or place of organization. The rationale for the reorganization provisions is set forth in Treas. Reg. §§ 1.368-1(b) (1955) and 1.1002(c) (1957). The Court of Claims has explained:

[C]ertain transactions constitute corporate readjustments and are not the proper occasion for the incidence of taxation. Congressional policy is to free from tax consequences those corporate reorganizations involving a continuity of business enterprise under modified corporate form and a continuity of interest on the part of the owners before and after, where there is no basic change in relationships and not a sufficient “cashing in” of proprietary interests to justify contemporaneous taxation.

King Enterprises, Inc. v. United States, 418 F.2d 511, 515 (Ct. Cl. 1969) (per curiam) (adopting opinion of Comm’r Bernhardt).

3. I.R.C. § 356(a)(1) provides:

(1) Recognition of gain

If—

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

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,
Taxation of this gain is governed by section 356(a)(2), which provides that if the exchange "has the effect of the distribution of a dividend," the recipient's recognized gain must be taxed as ordinary income to the extent of his or her ratable share of accumulated earnings and profits. Otherwise it is taxed at the more favorable capital gains rate. Determining when a boot distribution pursuant to a corporate reorganization is a dividend distribution within the meaning of section 356(a)(2) has puzzled courts, and no test or method of analysis has yet gained general acceptance.

The Court of Appeals for the Fifth Circuit recently confronted 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.

4. I.R.C. § 356(a)(2) provides:
   (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 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.

5. If the recognized gain is not treated as a dividend, it is "treated as gain from the exchange of property," id., thus qualifying for capital gains treatment. See I.R.C. §§ 1001(c), 1202, 1221-1223.

The following example demonstrates the application of §§ 354(a)(1) and 356(a). Mr. Shareholder owns 75% of the outstanding stock in corporation A, which has $100,000 in accumulated earnings and profits. In a corporate reorganization, he exchanges his stock in corporation A for stock in corporation B. The gain he realizes on the transaction is $150,000. Because the transaction merely involves an exchange of stock, this gain is not recognized for tax purposes unless and until he disposes of the stock in corporation B. But if instead he receives stock in corporation B worth $100,000 and cash of $50,000, the transaction becomes partially taxable. Two questions arise: (a) How much gain is subject to tax? and (b) Is the gain taxed as ordinary income or as a capital gain? In the above example, although the gain realized is $150,000, § 356(a)(1) limits the amount of gain presently taxable to the amount of boot received, $50,000. If the boot distribution is determined to have the effect of a dividend, it is deemed, under the definition of dividend in I.R.C. § 316, to be a distribution out of earnings and profits. Section 356(a)(2) limits the amount of boot subject to dividend treatment to the shareholder's ratable share of the accumulated earnings and profits of the corporation. In this example, the boot Mr. Shareholder received would be fully taxable as a dividend because it is less than $75,000, his ratable share of earnings and profits. If, however, Mr. Shareholder's share of the earnings and profits had only amounted to $40,000, then only $40,000 would be taxed as ordinary income and the balance of the boot payment, $10,000, would be taxed at the more favorable capital gains rate.

This Note addresses the issue in question (b) above: What is the appropriate standard by which a court should determine whether or not the distribution of boot has the effect of a dividend?
this issue in *Shimberg v. United States*. The court concluded that the boot distribution should be treated as a dividend if it would have been taxed as a dividend had the distribution been made by the acquired corporation before or in the absence of reorganization. This Note asserts that *Shimberg* effectuates a return to the now-discredited automatic-dividend rule. The dividend-equivalence test adopted in *Shimberg* should be rejected in favor of the standard formulated by the Eighth Circuit in *Wright v. United States*.

**SHIMBERG V. UNITED STATES**

*Publicly Held Corporation Swallows Closely Held Corporation*

The taxpayer, Mandell Shimberg, Jr., owned 66.8% of the stock in La Monte-Shimberg Corporation (LSC), a closely held corporation engaged in home construction and sales. LSC's corporate existence terminated when it merged with MGIC Investment Corporation (MGIC), a publicly held corporation engaged in the financial guarantee business. The LSC shareholders received pro rata $625,000 in cash and 32,132 shares of MGIC common stock in exchange for their LSC stock. In addition, 32,132 shares were placed in escrow to be delivered to the former LSC shareholders in five years if conditions of the agreement were met. Shimberg received $417,449 plus 21,461 shares of common stock and an equal

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7. Id. at 288.
9. 482 F.2d 600 (8th Cir. 1973). For discussion of Wright, see text accompanying notes 40-42 infra.
number of the escrow shares in exchange for his stock.\textsuperscript{12} This constituted less than one percent of MGIC's outstanding stock.\textsuperscript{13} Shimberg's gain on the transaction exceeded the boot he received; thus the amount of gain taxable under section 356(a)(1) is $417,449, the amount of boot.\textsuperscript{14} The controversy was whether the boot should be treated as a dividend and taxed as ordinary income or accorded the more favorable capital gains treatment. Shimberg's ratable share of LSC's accumulated earnings and profits exceeded the boot he received.\textsuperscript{15} The district court held that since Shimberg suffered a meaningful reduction in his proportionate interest in the corporation as a result of the reorganization,\textsuperscript{16} the pro rata boot distribution is not equivalent to a dividend distribution even in the presence of sufficient earnings and profits.\textsuperscript{17} The court of appeals rejected this approach and determined that the distribution was taxable as a dividend because a pro rata distribution to shareholders out of corporate earnings and profits would have been taxed as a dividend if it had been made prior to or in the absence of the reorganization.\textsuperscript{18}

\textbf{Shimberg in Perspective}

To appreciate properly the different tests applied by the district court and the court of appeals determining dividend equivalence under section 356(a)(2), it is necessary to trace the development of the law from the Supreme Court's seminal decision in \textit{Commissioner v. Estate of Bedford}\textsuperscript{19} through the Eighth Circuit's opinion in \textit{Wright v. United States}.\textsuperscript{20} The corporation in \textit{Bedford} exchanged preferred stock for new preferred stock, common stock,  

\begin{enumerate}
\item[12.] 577 F.2d at 285.
\item[13.] \textit{Id.} at 286.
\item[14.] Although the amount of gain realized by Shimberg on the transaction is not disclosed in the opinion, it is clear that it must have exceeded $417,449. Under I.R.C. § 356(a)(1) the recognized gain is limited to the amount of boot. \textit{See} notes 3 & 5 supra.
\item[15.] "Immediately prior to the merger, the undistributed earnings and profits of both corporations were in excess of $625,000 each." 577 F.2d at 285 (footnote omitted). The amount of cash distributed pursuant to the plan of reorganization was $625,000. If Shimberg's share of earnings and profits had been less than $417,449, for example, $400,000, then only $400,000 would have been eligible for taxation as ordinary income under § 356(a)(2). \textit{See} notes 4 & 5 supra.
\item[16.] This test emanates from the Supreme Court decision in \textit{United States v. Davis}, 397 U.S. 301 (1970). \textit{See} text accompanying notes 36-38 \textit{infra}.
\item[17.] 415 F. Supp. at 836-37.
\item[18.] 577 F.2d at 289-89.
\item[19.] 325 U.S. 283 (1945).
\item[20.] 482 F.2d 600 (8th Cir. 1973).
\end{enumerate}
and cash pursuant to a recapitalization plan. Bedford's estate realized a gain on the transaction, and the cash payment it received was less than its ratable interest in the corporation's accumulated earnings and profits. The Supreme Court found that the cash distribution in the presence of earnings and profits is considered a distribution of such earnings and profits regardless of whether the corporation's capital is also reduced. The Court held "that a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within § 112(c)(2) [the predecessor of section 356(a)(2)]."

For many years, the broad language in Bedford was interpreted as automatically requiring any gain recognized in connection with a corporate reorganization to be treated as income taxable as a dividend to the extent of the shareholder's ratable share of the distributing corporation's accumulated earnings and profits. This so-called "automatic dividend" rule has been criticized because it is inconsistent with the statutory language and legislative history of section 356(a)(2). Recently courts and the Internal Revenue Service (Service) have retreated from it.

Courts faced with the task of defining dividend equivalence for purposes of section 356(a)(2) so as not to compel the "automatic dividend" result have looked to other sections of the Code for

21. A reorganization is defined to include recapitalization. I.R.C. § 368(a)(1)(E).
22. 325 U.S. at 289. Bedford was decided under § 112(c)(2) of the 1939 Internal Revenue Code, Int. Rev. Code of 1939, ch. 1, § 112(c)(2), 53 Stat. 39 (now I.R.C. § 356(a)(2)). The maximum amount of dividend income that could arise under the predecessor provision of § 356(a)(2) was limited to the amount of boot.
23. 325 U.S. at 292.
24. Id.
guidance. These courts have realized that the wording of sections 356 and 302 coincide, suggesting a similar test for dividend equivalence in reorganization distributions as that applied to distributions incident to stock redemptions.29 In Ross v. United States,30 for example, the Court of Claims stated: "The problem of dividend equivalence usually arises in reorganization cases under § 356 . . . and in redemption cases under § 302 . . . . The phrase 'has the effect of the distribution of a dividend' in § 356 . . . is in pari materia with the phrase 'essentially equivalent to a dividend' as used in § 302 . . . ."31 This reasoning justifies using principles developed under section 302 to determine dividend equivalence under section 356(a) although there is no express statutory relationship between the sections, and this has occurred with increasing frequency.32 Following its abandonment of the automatic-dividend rule, the Service cryptically noted that "in appropriate cases" section 302 principles "may serve as useful guidelines" for determining dividend equivalence under section 356(a)(2).33

**Stock Redemption Principles: The Meaningful Reduction Test**

Section 302(b)(2) provides that gain recognized incident to a stock redemption will be taxed as proceeds from the sale of a capital asset if the redemption is "substantially disproportionate with respect to the shareholder."34 A redemption is deemed "substantially disproportionate" if the shareholder's postredemption interest (a) is less than eighty percent of his or her preredemption interest and (b) does not exceed fifty percent of the voting power of the corporation. If the shareholder does not fall within the so-called

31. Id. at 797 (citations omitted).
safe harbors of section 302(b)(2), he or she may still qualify for preferred tax treatment "if the redemption is not essentially equivalent to a dividend" within the meaning of 302(b)(1).\footnote{35}

The leading authority interpreting section 302(b)(1) is United States v. Davis.\footnote{36} The taxpayer in Davis directly or indirectly owned fifty percent of the common stock\footnote{37} of the corporation and all of the preferred stock. The preferred stock had been issued to enable the corporation to increase its working capital, thereby qualifying for a pending loan application. After the loan was repaid the stock was redeemed pursuant to the original understanding.

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\footnote{35} I.R.C. § 302(b)(1). I.R.C. § 302 provides in part:

(a) General rule

If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

(b) Redemptions treated as exchanges

(1) Redemptions not equivalent to dividends

Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.

(2) Substantially disproportionate redemption of stock

(A) In general

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

(B) Limitation

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

(C) Definitions

For purposes of this paragraph, the distribution is substantially disproportionate if—

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

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

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

\footnote{36} 397 U.S. 301 (1970).

\footnote{37} Taxpayer and his wife each owned 25% of the corporation’s common stock. Under I.R.C. § 318(a), an individual is deemed to own, directly or indirectly, stock owned by his or her spouse and other specified family members for certain purposes, including that under consideration in Davis. See 397 U.S. at 305 & n.4.
Holding the distribution taxable as a dividend, the Supreme Court reasoned:

If a corporation distributes property as a simple dividend, the effect is to transfer the property from the company to its shareholders without a change in the relative economic interests or right of the stockholders. Where a redemption has that same effect, it cannot be said to have satisfied the "not essentially equivalent to a dividend" requirement of § 302(b)(1). Rather, to qualify for preferred treatment under that section, a redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation.\textsuperscript{38}

This standard presents difficulties where the reorganization involves two corporations that have merged. The taxpayer changes status from a shareholder in one corporation to a shareholder in another corporation. The problem is determining what standards should be used to compare the taxpayer's interest in the old corporation with his or her interest in the new corporation in order to determine whether a meaningful reduction in proportionate interest has occurred. The district court in Shimberg compared the taxpayer's percentage interest in the acquired corporation before the merger with his percentage interest in the postmerger corporation. The court emphasized that prior to the merger, Shimberg, as the chief executive officer and majority stockholder in LSC, was effectively able to control its operations. However, after the merger he owned less than one percent of the stock of a large publicly held corporation whose stock was held by approximately 5,200 shareholders and was traded on the New York Stock Exchange. By using this basis for comparison, the district court reached the foregone conclusion that the merger resulted in a meaningful reduction in Shimberg's interest in the continuing corporation. The court characterized the transaction as a sale by Shimberg and the other LSC stockholders to MGIC for cash and marketable securities in a publicly held corporation;\textsuperscript{39} thus the capital gains rate would apply.

\textit{Wright v. United States}\textsuperscript{40} interpreted the meaningful reduction standard somewhat differently. The taxpayer was the majority stockholder in three closely held corporations. Under a reorganization plan, two of the corporations were consolidated into a single

\textsuperscript{38} 397 U.S. at 313 (emphasis added).

\textsuperscript{39} See 415 F. Supp. at 836-37.

\textsuperscript{40} 482 F.2d 600 (8th Cir. 1973). For further discussion of Wright, see Kennedy, \textit{Boot received in acquisitive reorganizations: What is the prospect for capital gains?} 41 J. TAX. 288 (1974).
new corporation. The taxpayer and the other shareholders exchanged their stock in the two consolidated corporations for stock in the new corporation. Taxpayer also received a promissory note not issued on a pro rata basis to the other shareholders. The Eighth Circuit agreed with the Commissioner that section 356(a)(2) should be read in pari materia with section 302 to determine whether issuance of the promissory note had the effect of a dividend distribution.\textsuperscript{41} It examined whether the taxpayer has suffered a meaningful reduction in his proportionate interest in the corporation as a result of the consolidation. Significantly, the court did not compare taxpayer's preconsolidation and postconsolidation percentage interests in the abstract to determine whether he had suffered a meaningful reduction in interest. The taxpayer's percentage change of ownership was computed by comparing (a) what his interest in the new corporation would have been if he had received only stock and no boot with (b) what his interest in the new corporation actually was. Thus the court viewed the transaction as if the new corporation had redeemed a portion of its stock from taxpayer after the consolidation and given taxpayer the promissory note in exchange.

The court found that if taxpayer had not received boot, he would have owned 85% of the stock in the new corporation. But because part of the consideration consisted of boot, he owned 61.7% instead. Thus taxpayer's proportionate interest in the new corporation was reduced by 27.4%; the court deemed this sufficiently meaningful under \textit{Davis} to qualify for capital gains treatment.\textsuperscript{42}

\textsuperscript{41} 482 F.2d at 605.

\textsuperscript{42} Id. at 607-10. Taxpayer's change in ownership is computed by calculating the percentage of stock taxpayer did receive from the total stock he or she would have received absent the boot distribution. In \textit{Wright} taxpayer received 61.7% out of 85%, or 72.6% of the amount he would have received absent the boot. Thus taxpayer's interest was reduced by 27.4%. The taxpayer in \textit{Wright} did not fall within the safe harbors of § 302(b)(2). Although the percentage reduction in his interest was more than the statutory 20% (i.e., his postredemption interest was less than 80% of his preredemption interest) he still owned more than 50% of the voting stock of the corporation after the redemption. Had the shareholder owned less than 50% of the voting power of the corporation after the redemption, he would have been protected under § 302(b)(2) and thus would have been automatically entitled to capital gains treatment. Section 302(b)(1) is available to the shareholder in circumstances where the percentage reduction in interest is less than 20%. The taxpayer can argue that his or her actual percentage reduction is sufficiently "meaningful" to qualify for capital gains treatment. \textit{See} text accompanying note 38 \textit{supra}. As yet no percentage has consistently been found to constitute a meaningful reduction. This question thus continues to be determined on a case-by-case basis. \textit{See} Zinn & Silverman, \textit{Redemptions of Stock Under Section 302(b)(1)}, 32 \textit{TAX LAW}. 91, 97 (1978).
In reversing the district court decision in *Shimberg* the Fifth Circuit recognized that there may be appropriate instances where stock redemption principles are helpful in interpreting section 356(a)(2) but agreed with the Commissioner that this was not such a case. The court asserted that to apply stock redemption principles in *Shimberg* is “akin to hunting ducks with a deer rifle, since there are fundamental differences between the redemption of stock in a single corporation and the reorganization of two or more corporations that results in a 'boot.'”

Without commenting on the soundness of the *Wright* decision, the court relied on significant factual differences between *Shimberg* and *Wright*. In *Wright* there were three separate corporations before merger. Two corporations were merged in such a manner that the two controlling shareholders owned the newly merged corporation in roughly the same proportionate relationship as they owned the third corporation. To achieve this result, the plan of reorganization required that one of the shareholders receive a boot payment. The identity of the controlling shareholders was the same premerger and postmerger although the proportional relationship changed, and the distribution was not pro rata. In such circumstances even the *Shimberg* court agreed it was not “illogical” to apply the meaningful reduction test since the transaction could be viewed as a redemption of a single shareholder’s stock by a single corporation.

Conversely, in *Shimberg* no commonality of ownership existed, and the boot distribution was pro rata. The court of appeals concluded that applying the meaningful reduction test “would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation’s shareholders, unless the same shareholders control both corporations.”

This interpretation of the meaningful reduction test misconstrues *Wright*. A meaningful reduction in a taxpayer’s interest is inevitable in the situation described in *Shimberg* only if the test is limited to a comparison between the taxpayer’s premerger percent-

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43. 577 F.2d at 287.
44. Id. at 290.
45. Id. at 287.
46. Id. at 288.
age interest in the old corporation with the taxpayer's postmerger percentage interest in the new corporation. This is how the district court applied the test in Shimberg. But this analysis is contrary to that advocated in Wright. The court in Wright applied the meaningful reduction test by determining how much stock the taxpayer is entitled to in the surviving corporation if taxpayer receives only stock and no boot in exchange for his or her stock in the old corporation. By comparing this amount with the stock taxpayer receives instead, the court calculated the reduction in taxpayer's proportionate interest in the surviving corporation. The transaction is viewed as a fictional redemption of taxpayer's stock by the newly formed corporation equivalent to the value of boot. To apply the Wright analysis to Shimberg, it is necessary to compare Shimberg's fictional and actual ownership in the surviving corporation: That comparison is between the stock he would have received absent boot and the stock he actually did receive. This difference determines whether the percentage reduction in interest is sufficient to qualify for capital gains treatment either because it is substantially disproportionate within the meaning of section 302(b)(2) or "meaningful" under Davis' interpretation of section 302(b)(1).

Upon rejecting the district court's formulation of the meaningful reduction test, the court of appeals in Shimberg determined that the proper standard for dividend equivalence under section 356(a)(2) is whether the distribution would have been taxed as a dividend if it had been made by the acquired corporation before or in the absence of the reorganization. If the distribution would have been taxed as a dividend in such circumstances, a different result is not warranted merely because the distribution occurs pursuant to reorganization.

The court determined that the meaning of dividend for purposes of section 356(a)(2) is provided by the definition in section 316, which defines dividend as "any distribution of property made by a corporation to its shareholders" out of earnings and profits; every distribution is considered to have been "made out

48. On the facts of Shimberg, it seems likely that the taxpayer would have qualified for capital gains treatment under the safe harbor provisions of § 302(b)(2). See 415 F. Supp. at 836 n.5.
49. See 577 F.2d at 288-89.
50. Id. at 288.
51. I.R.C. § 316(a).
of earnings and profits to the extent thereof." Because his pro rata share of the premerger earnings and profits of LSC exceeded the boot Shimberg received, the court concluded that his entire boot distribution should be treated as a dividend.

The Fifth Circuit's interpretation of section 356(a)(2) is unsupported by statute, legislative history, or judicial interpretation. Moreover, because the determination of dividend distribution is reached by focusing solely on the acquired corporation's earnings and profits without taking into account other circumstances surrounding the boot distribution, this standard effectively converts any recognized gain into dividend income to the extent that earnings and profits are available. Bedford has been criticized and rejected because it produces this same result.

A literal interpretation of section 356(a)(2) does not support the conclusion that Congress intended automatically to treat boot distributions in the presence of sufficient accumulated earnings and profits as distributions of dividends. The special circumstances the boot dividend rules of section 356(a)(2) were designed to govern require an independent dividend test apart from the section 316 definition of dividend. For example, "[i]f a shareholder realized no gain on the exchange, section 356(a) . . . will not tax him, regardless of the existence of available accumulated earnings and profits; and, conversely, if there are current (but not accumulated) earnings and profits, there can be no boot dividend."

A comparison of section 356(a)(2) with the provisions of section 356(b) and (e) also supports the conclusion that section 356(a)(2)

52. Id. There are exceptions to this rule, but they are not relevant to the situation in Shimberg. See I.R.C. § 316(b).
53. See note 15 supra.
54. See authorities cited in note 26 supra. The Shimberg court denied that its decision signalled a return to the discredited automatic-dividend rule. 577 F.2d at 290 & n.19.
55. The Court of Claims in Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl.), cert. denied, 358 U.S. 832 (1958), observed: "If Congress meant merely to say that any boot money at all paid out of earnings should be a taxable dividend, it used a verbose and complicated way of saying it." Id. at 809.
56. B. Bittker & J. Eustice, supra note 25, § 14.34, at 14-117 to -118. Wright also asserts that § 316 cannot provide a complete definition of dividend for purposes of § 356(a)(2). 482 F.2d at 605.
57. Gerson, supra note 26, at 845 (footnote omitted).
58. See I.R.C. § 356, which provides in part:
(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
does not automatically give rise to dividend income. In these sub-
sections, Congress explicitly provides for automatic-dividend treat-
m ent; the noticeable absence of such language in section 356(a)(2)
substantiates the inference that this section requires a more flexible
interpretation.\textsuperscript{59}

The court of appeals maintained that the legislative history of
section 356(a)(2)

makes clear that a distribution that would have been a dividend
if made prior to the reorganization is subject to the same treat-
m ent when made as part of the transaction.

. . . Indeed, the legislative history of the predecessor to
\$ 356(a)(2) offers virtually the same fact situation as an example
of a transaction having the effect of a dividend distribution.\textsuperscript{60}

A careful reading of the legislative history does not support
the court's interpretation. The predecessor of section 356(a)(2)\textsuperscript{61}
was designed to eliminate a specific tax-evasion scheme. The
committee reports provide an example of the type of scheme to be
avoided: A corporation that transfers all its assets to a sham corpo-
ration, thus enabling surplus cash to be distributed to the sharehold-
ers of the transferor corporation.\textsuperscript{62} Shimberg is significantly differ-

\begin{itemize}
  \item 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 \textit{shall be treated as a}
  \textit{distribution of property to which section 301 applies.}
  \item (e) Exchanges for section 306 stock
  \begin{quote}
    Notwithstanding any other provision of this section, to the extent that
    any of the 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) \textit{shall be treated as a distribution of property to}
    \textit{which section 301 applies.}
  \end{quote}
  I.R.C. \$ 356(b), (e) (emphasis added).
\end{itemize}

\textsuperscript{59} B. BITTKER \& J. EUSTICE, supra note 25, \$ 14.34, at 14-118.
\textsuperscript{60} 577 F.2d at 288-89 (citations omitted) (footnote omitted).
\textsuperscript{62} The House Report states:
There is no provision of the existing law which corresponds to paragraph (2)
of subdivision (d). This subdivision 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 and not as a taxable gain.

The necessity for this provision may best be shown by an example: Cor-
poration A has capital stock of $100,000, and earnings and profits accumu-
lated since March 1, 1913, of $50,000. If it distributes the $50,000 as a divi-
dend to its stockholders, the amount distributed will be taxed at the full
surtax rates.

On the other hand, corporation A may organize corporation B, to which
There is no hint that tax evasion motivated the reorganization. Furthermore, other courts have found that the legislative history of section 356(a)(2) is unhelpful in determining its meaning. Justice Frankfurter's comment in *Bedford* is illustrative:

The history of the legislation is not illuminating. . . . [T]he reports of the Congressional Committees merely use the language of the section to explain it. . . . We are thrown back upon the legislative language for ascertaining the meaning which will best accord with the aims of the language, the practical administration of the law and relevant judicial construction. 63

The court in *Shimberg* cited several decisions where boot distributions were held taxable as dividends. 64 However, these cases should not have been controlling in *Shimberg*. Since the cases cited by the *Shimberg* court were all decided prior to the Supreme Court's enunciation of the meaningful reduction test in *Davis* and the *Wright* court's interpretation of this standard, their precedential value is uncertain. Moreover, there are significant factual distinctions between these cases and *Shimberg*. In the frequently cited case of *Hawkinson v. Commissioner*, 65 for example, indebtedness of a shareholder to a corporation was cancelled in accordance with a consolidation plan. The equity interest of the shareholder in the consolidated corporation was reduced to reflect the cancellation

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63. 325 U.S. at 290 (citations omitted).
64. 577 F.2d at 288 (citing *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Rose v. Little Inv. Co.*, 86 F.2d 50 (5th Cir. 1936); *Commissioner v. Owens*, 69 F.2d 579 (5th Cir. 1934); *King Enterprises, Inc. v. United States*, 418 F.2d 511 (Cl. Ct. 1969) (per curiam) (adopting opinion of Comm'r Bernhardt); *Ross v. United States*, 173 F. Supp. 793 (Cl. Ct.), cert. denied, 361 U.S. 875 (1959).
of indebtedness. Because of the boot—the amount of the cancellation of indebtedness—the shareholder received 33,524 shares in the consolidated corporation rather than 36,180, the number of shares to which she otherwise would have been entitled. The Second Circuit held that the boot distribution was equivalent to a dividend because "the so-called reduction of interest was in reality a preservation of the economic status quo by a realistic alignment of ownership in the new corporation to reflect its productive assets." The court in Hawkinson, focusing on the whole transaction, was probably motivated because the reorganization did not result in any significant change in voting power. A Wright analysis would likely have yielded a similar result because the shareholder in Hawkinson only suffered a 7.3% reduction in her interest in the surviving corporation—arguably not sufficiently meaningful under Davis to avoid dividend treatment.

The Shimberg court recognized that the effect of a boot payment under section 356(a)(2) must be determined in light of all the facts and circumstances surrounding its distribution. But by considering what effect the distribution would have absent reorganization, the Shimberg test fails to give the fact of reorganization any weight at all. The economic reality of the situation is that, absent reorganization, the boot distribution would not have been made. If the distribution is analyzed from the perspective of the acquired corporation only, in circumstances unrelated to reorganization, and the distribution is made on a pro rata basis, it necessarily will be treated as a dividend to the extent of the acquired corporation's earnings and profits. Such a result is a throwback to Bedford.

Generally speaking, a distribution of property to a shareholder has the effect of a dividend if, as a result, the relative ownership interests of the shareholders are not affected. Receipt of an ordi-

66. 235 F.2d at 749-50. Using a Wright analysis, her equity interest in the corporation was reduced because of the boot by 7.3%.
67. Id. at 751.
68. See 577 F.2d at 290 n.19. The requirement that a court consider all the facts and circumstances surrounding the transaction to determine when a boot distribution has the effect of a dividend is similar to the step-transaction doctrine requirements. Under this doctrine, as the Shimberg court explains, "all parts of a multi-step exchange or reorganization are grouped together to determine the appropriate tax treatment for the entire transaction, if the several steps are an essential and integral part of the overall plan." Id. at 289. The distribution of cash to LSC shareholders was clearly an integral part of the overall transaction. The Shimberg court denied that its decision violates the step-transaction doctrine. Id. at 289-90.
nary dividend leaves the shareholder in the same position vis-a-vis other shareholders and the corporation as he or she occupied before the receipt of the dividend; as the owner of stock, his or her right to vote, participate in earnings, and share in the assets of the corporation upon liquidation remain unchanged.\textsuperscript{71}

Where, however, the distribution does produce a change in the shareholder’s ownership interests or rights, the distribution should no longer be treated as a dividend. In \textit{Idaho Power Co. v. United States},\textsuperscript{72} for example, the holders of six- and seven-percent preferred stock in a public utility were given the option of either exchanging their stock for new four-percent preferred stock plus eight dollars per share, or redeeming their stock at $110 per share. Two-thirds of the holders elected to exchange their stock. As a consequence of reorganization, the preferred stockholders’ status was drastically changed: Both the rate of return of their investment and their voting power were substantially reduced.\textsuperscript{73} Accordingly, the Court of Claims ruled that the gains recognized by the preferred stockholders on the exchange should be taxed as a capital gain and not as ordinary income.

Although the \textit{Shimberg} court did not challenge the general relevance of stock redemption principles for construing section 356(a)(2), it was reluctant to “haphazardly” apply such principles to the reorganization context.\textsuperscript{74} The court’s refusal to adopt the meaningful reduction test is based on the incorrect assumption that whenever applied in situations like that in \textit{Shimberg}—huge publicly held corporation swallowing small closely held one—the taxpayer will \textit{always} suffer a meaningful reduction in his or her proportionate interest in the corporation.\textsuperscript{75} As previously demon-

\textsuperscript{71} These are the most commonly cited attributes of stock ownership. See, e.g., Himmel v. Commissioner, 338 F.2d 815, 817 (2d Cir. 1964).
\textsuperscript{73} The rate of return was reduced form 6% or 7% to 4%, a reduction of 33% or 42% respectively. Prior to reorganization, separate concurrence of the common stockowners was unnecessary to authorize issuance of additional preferred stock. Pursuant to the reorganization plan, however, the voting power of the common stockholders was increased to prohibit future issuance of preferred stock without their concurrence. Id. at 810.

It is interesting to note that in \textit{Idaho Power Co.} the taxpayer argued for dividend treatment while the Commissioner argued for capital gains treatment. The general pattern was reversed because the corporate taxpayer was claiming a dividends-paid credit under the predecessor provision of I.R.C. § 243(a)(1). Id. at 808.
\textsuperscript{74} 577 F.2d at 287, 290 n.18.
\textsuperscript{75} Id. at 288.
strated, however, a proper application of the Wright test does not compel this conclusion.

As Wright indicates, a change in a stockholder's rights is only relevant when determined in reference to the rights the shareholder should be entitled to in the corporation that continues to exist. If, then, the ultimate focus is on the stockholder's position when the entire transaction is consummated, the order in which the component parts of the transaction take place is irrelevant. This principle is illustrated in Zenz v. Quinlivan. The taxpayer in Zenz, owning all the outstanding shares in a corporation, wished to dispose of them to a competitor. Because the buyer believed the corporation's retained earnings and profits were a source of potential tax liability, the taxpayer could sell only a portion of her stock. Shortly after the sale, the acquired corporation distributed substantially all of its retained earnings to redeem the balance of the taxpayer's outstanding shares. The Sixth Circuit held that distribution of corporate earnings and profits was not dispositive and the effect of distribution had to be examined in light of all the facts. By viewing the transaction in its entirety, it became clear that taxpayer had intended to terminate her interest in the corporation. Accordingly, the court held that the distribution out of earnings and profits was not essentially equivalent to a dividend. The Service has accepted the Zenz rationale, declaring that "it is proper

76. See text accompanying notes 34-42 supra.
77. 482 F.2d at 607.
78. 213 F.2d 914 (6th Cir. 1954).
79. Under the provisions of § 302(b)(3), a redemption is treated as a sale of stock by the redeeming shareholder to the corporation when "the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder." I.R.C. § 302(b)(3). Gain recognized on the sale or exchange of a capital asset qualifies for capital gain treatment. I.R.C. §§ 1001(c), 1202, 1221-1223. If the taxpayer in Zenz had disposed of her entire shareholding pursuant to an agreement of sale, she clearly would have qualified for capital gains treatment on her recognized gain. In considering the circumstances surrounding the transaction the court concluded that in substance the transaction constituted sale of a capital asset. 213 F.2d at 917.
80. 213 F.2d at 917-18. Accord, McDonald v. Commissioner, 52 T.C. 82 (1969). In McDonald, the taxpayer owned all the outstanding preferred stock and the majority of the outstanding common stock. Pursuant to an agreement with a publicly held corporation whose stock was listed on the New York Stock Exchange, his preferred stock was redeemed and thereafter he exchanged his common stock for stock of the acquiring corporation. The court concluded, after considering the transaction as a whole, that the redemption of the preferred stock resulted in a substantial change in taxpayer's investment, and accordingly was not essentially equivalent to a dividend. Id. at 88-89.
to rely upon the holding in Zenz that the sequence in which the events . . . occur is irrelevant as long as both events [the sale and the redemption] are clearly part of an overall plan.”

If the taxpayer in Shimberg had received only MGIC stock, and a portion of that stock was subsequently redeemed by MGIC, he would have been entitled to capital gains treatment as long as the distribution was either substantially disproportionate within the meaning of section 302(b)(2) or not essentially equivalent to a dividend under section 302(b)(1). Thus the Shimberg analysis can lead to different results depending on the moment when the boot distribution is made. By focusing on the entire transaction Wright and Zenz assure similar treatment even if the distribution occurs simultaneously with or in contemplation of a merger.

CONCLUSION

Since the enactment of section 356(a)(2)’s predecessor in 1924, courts have struggled to formulate an appropriate standard for determining the effect of a distribution of boot within the meaning of section 356(a)(2). The trend in case law since the mid-fifties has clearly been towards rejection of a test that automatically leads to taxation of boot income as a dividend merely because earnings and profits exist. The Shimberg test is unsatisfactory because it compels this result.

The appropriate test must take into account all the facts and circumstances of the transaction: The change in the taxpayer’s investment, and the change in his or her rights vis-a-vis other shareholders and the corporation. Such a test is afforded by the Wright analysis, which views the transaction as if the shareholder first receives stock in the acquiring corporation equivalent to the value of his or her stock in the acquired corporation. A portion of this stock, equal to the boot shareholder receives, is considered to have been fictionally redeemed by the acquiring corporation. The shareholder will qualify for capital gains treatment on the boot received if, as a result of the fictional redemption, the reduction in his or her interest in the corporation is either substantially disproportionate within the meaning of section 302(b)(2), or sufficiently meaningful under Davis.

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