University of Richmond Law Review

Volume 13 | Issue 3 Article 12

1979

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Stephen Lee Dalton
University of Richmond

TAXATION OF BOOT RECEIVED DURING ACQUISITIVE REORGANIZATION: DIVIDEND V. CAPITAL GAINS

I. INTRODUCTION

Acquisitive reorganizations either by consolidation or statutory merger have become a popular means for corporations with surplus cash or treasury stock to diversify their investment base.[1] The tax treatment of cash received during such reorganizations is an often litigated and still unsettled area of the law. Such confusion is the product of inconsistent and irreconcilable case holdings and Revenue Rulings as the courts and the Internal Revenue Service have attempted to apply the myriad of judicial doctrines and intricate Code law dealing with this question to various factual situations.

Section 368(a)(1)(A)[2] of the Internal Revenue Code of 1954 sets out the standards that a transaction must meet to qualify as a statutory merger or consolidation reorganization. If a transaction falls within this definition, it is eligible for favorable tax treatment under section 354(a) of the Code.[3] Section 354(a) provides that in a section 368(a)(1) reorganization involving

1. Newsweek, Oct. 16, 1978, Vol. XCII, No. 16.

2. I.R.C., § 368 (a)(1)(A) provides:

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation.

3. I.R.C., § 354 (a) provides:

(a) GENERAL RULE.—

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

(2) LIMITATION.—Paragraph (1) shall not apply if—

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

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

(3) CROSS REFERENCE.—

For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

This also accounts for the popularity of the 368(a)(1)(A) reorganization. Under its terms the types of property distributed for the acquired company's stock are limited only by state law. This leaves the parties to the reorganization great flexibility in constructing the exchange and still allows them to fall within the non-recognition section of 354 when applicable.

See, e.g., FLA. STAT. ANN § 607-234 (West 1977); DEL. CODE. tit. 8, § 252 (Supp. 1977).

a stock-for-stock exchange there will be no recognition of gain or loss.[4] The nonrecognition of gain in exchange accounts for the popularity of section 368(a)(1)(A) reorganizations.

Section 368(a)(1)(A) also allows an exchange of money or other property in addition to a stock-for-stock exchange if permitted by state law. This additional money or other property is the "boot"[5] received during reorganization. The method of taxing such boot is governed by section 356(a)[6] of the Code which requires that such a distribution of boot be taxed as capital gain if it does not "have the effect of a dividend." If the boot has "the effect of a dividend" then it will be treated as ordinary income under section 301.

Recently, the difficulty in determining the proper interpretation of section 356 has manifested itself in *Shimberg v. United States.*[7] The decision has offered little guidance in determining whether "boot" is to be taxed as capital gains or ordinary income. A satisfactory analysis of *Shimberg* first requires a historical survey of the statutes and case law concerning the taxation of boot.

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4. Non-recognition of gain or loss during corporate reorganization is based upon two separate principles. First: In an exclusive stock for stock exchange there is no desire to tax individuals who have merely changed the form of their investments, reserving tax treatment until such gain or loss on the exchange is realized. S. REP. No. 617, 65th Cong., 3d Sess. 5 (1918); H. R. REP. No. 1622, 83d Cong., 2d Sess. 42 (1954); H. R. REP. No. 1432, 67th Cong., 4th Sess. 3 (1923).

Second: It was deemed undesirable to tax such business readjustments which result from and are essential to the growth of a thriving economy. *See Hearings on H.R. 8300 Before the Senate Committee on Finance,* 83d Cong., 1st Sess., pt. 2 at 1305, 1323 (1953) and pt. 4 at 1904 (1954).

5. The use of the term "boot" signifies "money-to-boot" exchanged during corporate reorganization. *See* Liddon v. Commissioner, 230 F.2d 304 (6th Cir.), *cert. denied,* 352 U.S. 824 (1956).

6. I.R.C. §356 (a) provides:

(a) GAIN ON EXCHANGES.—

(1) RECOGNITION OF GAIN.—If—

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

(B) the property received in 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,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

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

7. 577 F.2d 283 (5th Cir. 1978).

II. Development of Section 356

The legislative history of section 356 is both brief and nebulous.[8] The predecessor of section 356 was section 202 (e) of the Revenue Act of 1921.[9] By 1924 Congress became cognizant that under section 202(e) a taxpayer could acquire dividends from his corporation as "boot" under the cover of a sham reorganization.[10] The attempted solution to this problem was section 203(d)(2) of the Revenue Act of 1924.[11] This was only a partial solution, however, which taxed boot received as ordinary income if it "had the effect of a dividend." The shortcomings were two-fold. Section 203(d)(2) still allowed sham reorganizations for tax avoidance in certain circumstances (discussion *infra*). Further, Congress had not distinguished between two fundamentally different types of transactions within the framework of a reorganization. In one, where property is exchanged with a third party for similar property and boot, and the property given up is a capital asset, ordinary income would not result. In the other, in which stock or securities are surrendered to one's own corporation for similar property and boot, ordinary income may result.[12] The distinction is between the entities with

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8. Justice Frankfurter, commenting on the difficulties in interpreting § 112(c)(2) of the Revenue Act of 1939 (the predecessor of § 356(a)) and the dearth of legislative history said, "The history of this legislation is not illuminating. . . . [W]e 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 law and relevant judicial construction." Commissioner v. Bedford, 325 U.S. 283, 290 (1945).

9. Rev. Act of 1921, ch. 136, §202(e), 42 Stat. 227, *as amended,* Act of March 4, 1923, ch. 294, §2, 42 Stat. 1560. To avoid confusion in the discussion in the text it is best to lay out a line of descent starting with §202(e) of the 1921 Revenue Act and following its various section numbers under changing codes. §202(e) was the predecessor of § 203(d)(2) of the Revenue Act of 1924, ch. 234, §203(d), 43 Stat. 257 which preceded §112(c)(2) of the Revenue Act of 1939, ch. 690, 49 Stat. 1648 which resulted in §356(a) of the current I.R.C.

10. In the Senate discussion of section 203(d)(2), the problem addressed was that of a substantially profitable corporation which forms, for tax purposes, a shell corporation having few or no assets. The original corporation then executes a merger with the new corporation which qualifies for reorganization non-recognition of gain. Pursuant to the merger the original corporation transfers all of its assets and stock to the shell corporation in exchange for the shell corporation's newly issued stock and cash from its newly acquired assets. The cash, representing the earnings and profits of the original corporation are distributed pro rata among the shareholders of the original corporation (who are now the shareholders of the shell corporation). Such a pro rata distribution of the original corporation's earnings and profits absent reorganization, would be a dividend, taxable as orindary income. Within the reorganizational framework it is treated as a capital gain. The purpose of the reorganization is primarily to avoid taxes. The precursor of section 356 was designed to prevent the withdrawal from corporate solution of property which the taxpayer can dispose of without substantially diluting his equity interests in the corporation under the guise of a reorganization. S. Rep. No. 398, 68th Cong., 1st Sess. 16 (1924); H.R. Rep. N. 179, 68th Cong., 1st Sess. 15, 52 (1924).

11. Rev. Act of 1924, ch. 234, §203 (d), 43 Stat. 257.

12. Moore, *Taxation of Reorganization Distributions,* 17 Tax L. Rev. 129, 130 (1961).

which the taxpayer is dealing in each instance. This left the question of tax treatment of boot distributed during legitimate reorganizations still unanswered.

Under section 203(d)(2) distribution of boot that "had the effect of a dividend" was characterized as ordinary income only to the extent that such a distribution did not exceed gain on the transaction as a whole.[13] This adjustment was immediately subject to abuse similar to its predecessor. Shareholders of profitable corporations whose stock had a low fair market value but a high basis, set up a sham reorganization with a shell corporation (i.e. one with substantially no assets) created by the original corporation. Under such an arrangement, the original corporation would transfer all of its assets, including cash, to the shell corporation in exchange for its stock and cash. This allowed the original corporation to simultaneously receive back the cash it had transferred. The cash would then be distributed by the original corporation to its shareholders and taxed as capital gains to the extent of the difference between the basis and present stock value.[14] The contradiction between congressional intent and the actual result left the courts in a quandary over the application of section 203(d)(2) and its successor, section 112(c)(2) of the Revenue Act of 1939.[15]

If the Senate recognized the problem it showed no indication of it. The 1954 Code revision left section 356, dealing with boot distributions during reorganizations, essentially the same as it had been since 1924.[16] In

13. Dividends were to be taxed at regular surtax rates rather than at capital gains rates as they were under the preceding 1921 provision. The "dividend-within-gain" limitation was another extension of favorable tax treatment that the Senate inserted. This was despite indications in debate and a proposed amendment that the House favored taxing all distributions of boot during reorganization without regard to gain. 65 CONG. REC. 2898-9 (1924). The proposed amendment was rejected by the Senate.

14. This was the very type of transaction, for the sole purpose of tax avoidance, that Congress attempted to eliminate. *See* note 10 *supra*. In such a transaction the shareholders of the new corporation are the same as the old, holding the same percentage interests in earnings and profits, liquidation and assets of the newly formed corporation both before and after the boot distribution.

15. *See* note 9 *supra*.

16. As in 1924, *supra* note 13, the House Ways and Means Committee attempted to amend §356 excising the provision that limited the dividend treatment of boot to the portion of the distribution that was not in excess of gain realized on the transaction as a whole. It also wished to substitute for the "has the effect of a dividend test" of 112(c)(2) one that would subject any distribution, whether or not made in connection with an exchange, to taxation at ordinary rates (to the extent of earnings and profits) unless, following the distribution, the stockholder owned no more than 80 percent of the percentage of participating stock he had owned prior to distribution. H. R. 8300, 83rd Cong., 2d Sess., §§302, 306 (1954). The Senate rejected both of these proposals. It is of interest to note that although the Senate stated that §356(a)(2) of the Internal Revenue Code of 1954 was identical to §112(c)(2) of the Internal

the absence of satisfactory congressional guidelines, the courts attempted to develop consistent application of the "having the effect of a dividend" test. Judicial efforts, however, were not always successful.

III. BEDFORD AND THE AUTOMATIC BOOT DIVIDEND RULE

The leading case concerning boot taxation during reorganization is *Commissioner v. Estate of Bedford.*[17] The *Bedford* case dealt with a recapitalization that qualified as a reorganizaton under the predecessor to section 368(a)(1)(E).[18] A corporation had issued new common and preferred stock and cash in exchange for outstanding preferred stock. Bedford's estate received common, preferred and cash for its outstanding preferred. The taxpayer argued that the cash received during the reorganization was not a dividend and therefore was entitled to capital gains treatment. This argument was accepted in the circuit court of appeals but the Supreme Court disagreed.[19] Since the corporation had undergone the recapitalization to permit payment of dividends under local law, the decision of the Supreme Court was undoubtedly correct.[20] However, the obfuscatory opinion handed down by the Court has since led to unresolved controversy.[21]

This controversy concerns what was the actual ruling of *Bedford.* It is arguable that *Bedford* only differentiated between shareholder return on

Revenue Code of 1939, the Senate version deleted the word "taxable" from before the word "dividend" as the 1939 Code was written in the phrase "having the effect of a dividend." S. REP. No. 1622, 83d Cong., 2d Sess. 268 (1954).

17. 325 U.S. 283 (1945).

18. I.R.C. § 368(a)(1)(E).

19. 1 T.C. 478 (1943), *rev'd,* 144 F.2d 272 (2d Cir. 1944), *rev'd,* 325 U.S. 283 (1945).

20. The Court based its decision on previous Tax Court cases which found dividend effect in the case of similar distributions during recapitalization of a single corporation. McCord v. Commissioner, 31 B.T.A. 342, 344 (19—); J. Weingarten, Inc. v. Commissioner, 44 B.T.A. 798, 808-9 (19—), Knapp Monarch Co. v. Commissioner I.T.C. 59, 69-70 (1943), *aff'd on other grounds,* 139 F.2d 863 (8th Cir. 1944). Coupling these decisions with an application of the Dobson rule, that the Supreme Court will not reverse a Tax Court decision unless there is a clear case of error, the Court reached what, at that time, was an obvious decision. Dobson v. Commissioner, 320 U.S. 489 (1943). The Dobson rule was subsequently modified in 1948 by an amendment to §1141 of the 1939 Code.

21. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 1434 at 14-92 (3d ed. 1971) [hereinafter cited as BITTKER AND EUSTICE]; Darrell, *The Scope of Commissioner v. Bedford's Estate,* 24 TAXES 266 (1946); Gerson, *Boot Dividends and the Automatic Rule: Bedford Revisited,* 11 W. & M. L. Rev. 841 (1969-70); Levin, Adess, McGaffey, *Boot Distributions In Corporate Reorganizations—Determination of Dividend Equivalency,* 30 TAX LAW., 287 (1976-77); Moore, *Taxation of Distributions Made in Connection with a Corporate Reorganization,* 17 TAX L. REV. 129 (1961); Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule,* 20 TAX LAW REV. 573 (1965); Wittenstein, *Boot Distributions and Section 112 (c)(2): A Re-examination,* 8 TAX L. REV. 63, 79 (1952).

a partial liquidation and a dividend. The case has been cited, however, by the Service and the courts as authority for equating section 112(c)(2) and its descendants with the automatic boot dividend rule.[22] This rule treats every distribution of boot during reorganization as "having the effect of a dividend" if sufficient earnings and profits are present.

If the automatic boot dividend rule is the proper interpretation of *Bedford*, it is by no means clear that such was the congressional intent behind section 356(a) (the descendant of 112(c)(2) which was at issue in *Bedford*). What was *not* done by Congress concerning section 356 sheds some light on what was done. While the legislative history is of little value, profitable comparisons with other Code sections can be made. As previously noted,[23] the House Ways and Means Committee had twice attempted to tax all distributions of boot received during reorganizations under a rule very similar to the automatic boot dividend rule. Both attempts had been expressly rejected by the Senate.[24]

Further evidence that supports rejection of the automatic boot dividend interpretation of section 356 comes from the construction of sections 356(b) & (e).[25] These sections were enacted to tax boot received during spinoffs[26] to the full extent of current or accumulated[27] profits and earnings without regard to the distributee's basis in stock and without consideration of the effect of the distribution of the boot.[28]

Also, non-recognition of gain is not granted in section 333(e) & (f)[29] nor in sections 1246 and 1248[30] of the 1954 Code. These provisions tax gain from certain exchanges of stock as ordinary income to the extent of the exchanging shareholder's ratable share of the earnings and profits of his corporation. This indicates that Congress intends to apply a more flexible ap-

22. *See, e.g.*, Commissioner v. Morgan, 288 F.2d 676 (3d Cir.), *cert. denied*, 368 U.S. 836 (1961); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949), *aff'g*, 10 T.C. 1080 (1948); Estate of Elsie W. Hill, 10 T.C. 1090 (1948); Rev. Rul. 55-220, 1955-1 C.B. 191.

23. *See* notes 13 and 16 *supra*.

24. The failure to adopt the 1954 House proposals and the enactment of §356 (b) are relevant in construing §356 (a). *See* United States v. Corell, 389 U. S. 299, 305 n. 20 (1967); Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965). *See also* note 30 *infra*.

25. I.R.C. § 356 (b) & (e).

26. This is an arrangement by which shareholders of a single corporation split up their investments among several corporate shells. A spin-off, as opposed to a dividend, is a distribution by one corporation of the stock of a subsidiary corporation. BITTKER & EUSTICE, *supra* note 21, ¶ 13.01 at 13-3.

27. Section 356(a) deals only with accumulated earnings and profits.

28. Treas. Regs. § 1.356.2 (b) example (2) (1955).

29. I.R.C. § 333(e), (f).

30. I.R.C. §§ 1246, 1248.

proach under section 356(a) than is applied in the above mentioned sections. The preceeding survey leads to the conclusion that Congress never intended section 356(a) to be a codification of the automatic boot dividend rule.[31] The use of the phrase "having the effect of a dividend" suggests that an analysis of the facts surrounding the distribution is required to determine if there is indeed such an effect. The test is similar to that employed under sections 302(b), 346(a)(2) and 306(c)(1)(B)(ii).[32]

The above proffered interpretation of section 356(a) has not prevailed though in the face of the *Bedford* decision and subsequent rulings. As a result there are several cases in which the Commissioner argued, and the court agreed, that the automatic boot dividend rule is in effect.[33] The Commissioner also has issued Revenue Rulings declaring the automatic boot dividend rule to be an accurate interpretation of section 356(a).[34]

A series of more recent cases has served to undermine these rulings and to bring the application of section 356(a) more in line with what legislative

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31. Comparing statutory use of different language in similar situations is a legitimate means for interpreting tax statutes. Mitchell v. Commissioner, 300 F.2d 533 (4th Cir. 1962). *Accord,* BITTKER & EUSTICE, *supra* note 21, ¶ 14.34 at 14-91-93; Gerson, *supra* note 21; Moore *supra* note 21.

32. I.R.C. §§ 302(b), 346(a)(2), 306(c)(1)(B)(ii). The test under § 302(b) is reprinted *infra* note 37. The test under § 346(a)(2) allows for the pro rata distribution to shareholders of the proceeds from a partial liquidation termed a "corporate contraction." Such a distribution will be given capital gain treatment if it is a) not "essentially equivalent to a dividend" b) is a redemption of a part of the stock of the corporation pursuant to a plan and c) occurs within the taxable year in which the plan is adopted or within the next succeeding taxable year. Interpreting this test in the case of Joseph W. Imler, 11 T.C. 836 (1948) (Acq.) the court, at 840, stated "The issue here raised presents a question of fact depending on the circumstances of the particular case . . . No sale or universally applicable test can be laid down. . . . "

Under section 306 the Code deals with a distribution of preferred stock to common shareholders in corporate recapitalizations sometimes used as a method of "bailing out" earnings and profits at capital gain rates. If the stock distributed is characterized under subsection (c) as section 306 stock, then any amount realized on the transfer is treated as ordinary income. The test for section 306 stock is a) it is not common stock b) the recipient shareholder's gain or loss went unrecognized to any extent by reason of Part III subchapter C (*i.e.* §§ 354 and 356) and c) the effect of the transaction was substantially the same as a stock dividend or it was received in exchange for section 306 stock. The Service's interpretation of this test indicates that it would examine all the circumstances surrounding such a recapitalization to determine the character of the stock distributed, including whether it was "substantially the same as a stock dividend." Rev. Rul. 56-116, 1956-1 C.B. 164; Rev. Rul. 57-212, 1957-1 C.B. 114.

33. Babcock v. Phillips, 327 F.2d 240 (10th Cir.), *cert. denied,* 387 U.S. 918 (1967); Breech v. United States, 23 Am. Fed. Tax R. 2d 69-489 (C. D. Cal. 1968); Isabella M. Sheldon, 6 T. C. 510 (1946); BITTKER & EUSTICE, *supra* note 21, ¶ 14.34 at 14-92. *See* note 22 *supra.*

34. Rev. Rul. 69-264, 1969-1 C.B. 102; Rev. Rul. 68-23, 1968-1 C.B. 144; Rev. Rul. 57-586, 1957-2 C.B. 249; Rev. Rul. 56-8 345, 1956-2 C.B. 206; Rev. Rul. 55-220, 1955-1 C.B. 191.

comparisons and logic would indicate to be an accurate interpretation. Several cases have questioned or rejected the automatic boot dividend rule[35] and the Commissioner, in some of these cases, has argued specifically that *Bedford* does *not* stand for the automatic boot dividend rule.[36] The problem that results is finding an acceptable definition of dividend in lieu of the automatic boot dividend rule.

In interpreting section 356(a) and its predecessors the Commissioner has argued, and the courts have agreed, that the "effect of the dividend" clause should be read in conjunction with section 302(b)[37] which defines what is not "essentially equivalent" to a dividend.[38] There also are Revenue Rul-

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35. Wright v. United States, 482 F.2d 600, 605 (8th Cir. 1973); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Ross v. United States, 173 F. Supp. 793 (Ct. Cl. 1959); Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958); Wilson v. United States, 46 T.C. 334 (1966); Bateman v. United States, 40 T.C. 408 (1963).

36. The Commissioner has argued that if Congress had meant merely to say that any boot money at all paid out of earnings and profits should be a taxable dividend, it used a "verbose and complicated way of saying it." Idaho Power Co. v. United States, 161 F. Supp. 807, 809 (Ct. Cl. 1958). *See* A. T. & T. v. United States, 306 F.2d 824 (2d Cir. 1962), *cert. denied*, 371 U.S. 950 (1963); King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); Ross v. United States, 173 F. Supp. 793 (Ct. Cl. 1958).

37. I.R.C. of 1954, §302(b) provides:

(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 the 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.

38. Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934); Bazely v. Commissioner, 331 U.S.

ings calling for the application of section 302(b) principles to section 356(a) in determining dividend equivalency.[39] A majority of the authorities and commentators acknowledge this application of dividend equivalency principles to section 356(a), as outlined in *Idaho Power v. United States*[40] and *Ross v. United States,*[41] as the most acceptable method of dealing with cash boots.[42]

In interpreting the "safe harbor"[43] exclusion under section 302(b)(1) the leading case is *United States v. Davis.*[44] The decision stated that for a distribution not to be considered a dividend, it must result in a meaningful reduction in the shareholder's proportionate interest in the corporation.[45] What constitutes a meaningful reduction in proportionate interest, however, is not at all clear.[46]

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737 (1947). In this case the government argued for the applicability of the predecessor of §302(b) as a "gloss" on the predecessor of §356(a). Wright v. Commissioner, 482 F.2d 600 (8th Cir. 1973); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958).

39. Rev. Rul. 74-515, 1974-2 C.B. 121. This ruling not only advocated application of § 302 to § 356(a) to determine dividend equivalency under appropriate circumstances but also it was aimed at removing any implication that Rev. Rul. 55-220, 1955-1 C.B. 191 stood for the application of the automatic boot dividend rule though it had been argued as such by the Commissioner. Rev. Rul. 74-516, 1974-2 C.B. 118; Rev. Rul. 75-83, 1975-1, C.B. 11. Both of these rulings apply § 302 to § 356 in determining "dividend effect" under § 356 without the qualification found in 74-515.

40. 161 F. Supp. 807 (Ct. Cl. 1958).

41. 173 F. Supp. 793 (Ct. Cl. 1959).

42. *E.g.*, BITTKER & EUSTICE, *supra* note 21, ¶14.34 at 14-92; Darrell, *supra* note 21; Kennedy, *Boot Received in Acquisitive Reorganizations: What is the Prospect for Capital Gains?*, 41 J. TAX. 288 (1974); Levin, Adess McGaffey, *supra* note 21.

43. If a distribution of money or other property in redemption of stock is not "essentially equivalent" to a dividend, then it is in the "safe harbor." That means it will be treated as payment in exchange for stock and any gain on such a distribution is treated as capital gain.

44. 397 U.S. 301 (1970).

45. *Id.* at 313.

46. § 302(b)(2) allows capital gains treatment for a cash distribution if, the shareholder's holding in the corporation is less than 80 percent of his preredemption holdings and he owns less than 50 percent of the corporation's voting stock after redemption. Under some circumstances it may also qualify for capital gains treatment under § 302(b)(1) even if he continues to own more than 50 percent of the corporation's voting power. Wright v. United States, 482 F.2d 600 (8th Cir. 1973); Rev. Rul. 75-502, 1975-2 C.B. 111. In several instances the Service has allowed capital gains treatment for a redemption although shareholder's interests were reduced by less than 20 percent. Rev. Rul. 76-385, 1976-2 C.B. 92; Rev. Rul. 75-502, 1975-2 C.B. 111. *See also* Rev. Rul. 76-364, 1976-2 C.B. 91 where a reduction from 27 percent to 22 percent was deemed a sufficient reduction to invoke capital gains treatment under § 302(a).

IV. The Shimberg Case

The case of *Shimberg v. United States*[47] resulted in a decision that closely follows the line of reasoning outlined immediately above. In this case a construction corporation, LaMonte-Shimberg Corporation (LSC) executed a merger agreement with MGIC Investment Corporation (MGIC). The agreement qualified as a statutory merger under section 368(a)(1)(A).[48] Pursuant to the agreement LSC exchanged all of its outstanding stock for 32,132 shares of MGIC common stock outright, 32,132 shares of MGIC common stock in escrow, and $625,000 cash. All of this was distributed pro rata among the shareholders of LSC. Taxpayer received $417,449 of the cash boot as his 66 per cent ownership of LSC warranted. He declared his share of the boot as a long term capital gain. The Internal Revenue Service disagreed claiming the cash had the effect of a dividend and assessed a federal income tax deficiency of $125,883 plus $16,169.93 interest. The taxpayer paid the assessment and then filed for a refund which was denied. He then brought suit in district court.[49] The district court characterized the boot as capital gain, although it is not clear which approach the court adopted. They based their finding on "an examination of the total transaction and its resulting effect upon the interests of the taxpayer as a stockholder."[50]

The Commissioner appealed this decision. In *Shimberg v. United States*[51] the Fifth Circuit Court of Appeals reversed the lower court's finding of capital gains treatment of the taxpayer's boot. The circuit court held first, that it would *not* apply section 302 dividend definitions to determine dividend equivalence under section 356(a). Although it noted the line of cases and Revenue Rulings cited above that indicated a judical and service preference for such an interpretation,[52] the court, without explanation, chose not to follow them. Instead of the widely favored method for dividend determination, the court chose a definition from a case decided before the 1921 Revenue Act, containing the relevant sections, was in effect.[53] This ignores the effect that 67 years of litigation have wrought upon this term in the Tax Code. It also ignores its interpretation in conjunction with the "having the effect of a dividend" test of section 356, which was not in existence until the Revenue Act of 1924.[54]

47. 415 F. Supp. 832 (M.D.Fla. 1976).
48. For text of statute, *see* note 2 *supra*.
49. 415 F. Supp. at 833-4.
50. 415 F. Supp. at 836.
51. 577 F.2d 283 (5th Cir. 1978).
52. *See* notes 38, 39, 42 *supra* and accompanying text.
53. 577 F.2d at 288, *citing* United States v. Phellis, 257 U.S. 156 (1921).
54. *See* text section II *infra*.

The court also stated: "[t]he theory behind tax free corporate reorganizations is that the transaction is merely 'a continuance of the proprietary interests in the continuing enterprise under a modified corporate form.' "[55] Upon these assumptions the court then stated that if there is a pro rata distribution of boot to shareholders of a corporation which is a party to reorganization and sufficient profits are available then such boot *must* have the effect of a dividend[56] (emphasis added). Despite disclaimers by the court,[57] this appears to be a return to the now discredited automatic boot dividend rule.[58]

The fundamental difference is how the district and circuit courts decided this issue rests upon the stage of the transaction at which each court determined the effect of the cash boot. The variance in the results was the product of different applications of the step transaction doctrine. It is necessary to examine this judicial doctrine to determine which court more accurately applied it to the facts of the instant case.

V. STEP TRANSACTION DOCTRINE

The step transaction doctrine is a judicial requirement that all integrated steps in a single transaction must be amalgamated in determining the true nature of a transaction.[59] This doctrine is applied in each area of tax law where it has any conceivable relevance.[60] The purpose behind this doctrine is to assure fair and accurate tax treatment of business transactions so neither the taxpayers nor the Commissioner artificially bifurcate such an exchange precipitating anomalous tax results.[61]

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55. 577 F.2d at 288, *citing* Lewis v. Comm'r, 176 F.2d 646, 648 (1st Cir. 1949); Treas.Reg. § 1.368-1(b). *Contra*, note 4 *supra*. Rather than a reorganization being "merely" anything BITTKER & EUSTICE notes that, "The reorganization provisions are extraordinarily complex, even for the Internal Revenue Code." BITTKER & EUSTICE, *supra* note 21, ¶14.01 at 14-6.

56. 577 F.2d at 288.

57. 577 F.2d at 290.

58. *See* notes 35 and 36 *supra* and accompanying text.

59. The step transaction doctrine was promulgated to deny independant tax validity to an interim step in a transaction which is not otherwise disturbed. American Potash & Chem. Corp. v. United States, 399 F.2d 194 (Ct. Cl. 1968). The step transaction doctrine is designed to look through the form of a transaction to its substance or reality. PAUL & ZIMET, STEP TRANSACTIONS, SELECTED STUDIES IN FEDERAL TAXATION 200, 254 (2d series 1938) [hereinafter cited as Paul & Zimet]; BITTKER & EUSTICE *supra* note 21, ¶14.51 at 14-102.

60. Krane, *Current Problems in Acquisitive Reorganizations*, 51 TAXES 737 (1973); BITTKER & EUSTICE, *supra* note 21, ¶14.51 at 14-101 to 102. *Compare* Comm'r v. Gordon, 391 U.S. 83 (1968); King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969); American Bantam Car Co. v. Comm'r, 11 T.C. 397 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

61. The courts have now developed three separate theories for applying the doctrine. One is the "binding commitment" test which requires the collapsing of several steps into one

There are two separate views on how this doctrine should be applied to acquisitive reorganizations. The problem facing the taxpayer is that they are both advocated by the Commissioner in separate and seemingly irreconcilable Revenue Rulings. In Revenue Ruling 75-83[62] the Service reviewed the case of *Wright v. United States*[63] which dealt with an acquisitive reorganization. It stated that the Service would view boot given by the acquiring corporation during reorganization as being distributed by the acquired corporation in a *separate transaction* before the exchange of stock between the two corporations. On this issue the Service ruled that it would *not* follow the court's decision in *Wright* to test the dividend equivalency of the boot distribution as it affected the outcome of the entire transaction. Under the Revenue Ruling, the Service treated the receipt of the boot as a dividend (up to the amount of accumulated earnings and profits). The *Wright* court, applying the "step transaction doctrine" saw the distribution as a constructive redemption by the acquiring corporation after the exchange of stock. This substantially reduced the taxpayer's interest in the resulting corporation and qualified the distribution for capital gains treatment.[64] It is suggested that the circuit court in *Shimberg* correctly followed

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transaction when, at the time the first step was entered into, there was a "binding commitment" to take the later steps. This variation was enforced where the taxpayer, rather than the Commissioner, as is usually the case, requested that the doctrine be applied. Comm'r v. Gordon, 391 U.S. 83 (1968).

Another theory is the "interdependence test" which requires inquiry as to whether, on a reasonable interpretation of objective facts, the steps in the transaction were so interdependent that the legal relations created by one transaction would have been fruitless without completion of the series. PAUL & ZIMET, *supra* note 55, at 254. *See also* Intermountain Lumber Co. v. Comm'r, 65 T.C. 1025 (1976); ACF-Brill Motors Co. v. Comm'r, 14 T. C. 263, 272 (1950), *aff'd,* 189 F.2d 704 (3d Cir. 1951); American Wire Fabrics Corp. v. Comm'r, 16 T.C. 607, 613 (1951).

The third theory of application is the "end results" test. Under this test purportedly separate transactions will be amalgamated into a single transaction when it appears that they were really component parts of a single transaction intended from the outset to be taken for the purpose of reaching the ultimate result. HERWITZ, BUSINESS PLANNING 804 (1966). *See also* Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184-5 (1942); Anheuser-Busch, Inc. v. Comm'r, 40 B.T.A. 1100 (1939), *aff'd sub nom,* Anheuser-Busch, Inc. V. Helvering, 115 F.2d 662 (8th Cir. 1940), *cert. denied,* 312 U.S. 699 (1941); South Bay Corp. v. Comm'r, 345 F.2d 698 (2d Cir. 1965).

62. 1975-1 C. B. 112.

63. 482 F.2d 600 (8th Cir. 1973).

64. The *Wright* court followed the Commissioner's argument in applying §302(b) to §356(a) in determining dividend equivalency of the distribution. Under § 302(b)(2) the distribution qualified as being substantially disproportionate in the court's view of the transaction thereby giving the taxpayer capital gains treatment on his share of the distribution. The court compared what the taxpayer would have received in stock had he received only stock and no boot to what he received with the boot. The difference between the two was deemed substantially disproportionate.

the precedent set by previous decisions and that Revenue Ruling 75-83 is an incorrect interpretation of how the step transaction doctrine should be applied to section 368(a)(1)(A) reorganizations and further that it leads to illogical and anomolous results.[65]

The tax treatment the Commissioner would have had the *Wright* court adopt is that during reorganization the relevant earnings and profits under the statute are those of the acquired corporation.[66] As a result it should be the shareholder's relation to the acquired corporation that is the determining factor in analyzing the receipt of boot. Not only is this an abrogation of the step transaction doctrine, it flies in the face of economic reality.[67]

The rationale of *Wright* has additional support in Tax Court cases and the Revenue Rulings interpreting them. In the case of *Zenz v. Quinlivan*[68]

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65. The surveyed commentators agree with unaminity. *See, e.g.*, 8 CAVITCH, BUSINESS ORGANIZATIONS §177.04 [3] at 1183 (1978 revision). The following example will show how Revenue Ruling 75-83 when applied to normal reorganization transactions will yield questionable results as to tax treatment. Assume there are two corporations, X and Y, each with 100 shares of stock outstanding. Also assume that there are two individuals A, who owns 100 percent of X and 20 percent of Y, and B, who owns 80 percent of Y. The two corporations consumate a merger agreement under § 368(a)(1)(A) in which A will receive 100 shares of the surviving corporation and $10 cash and B will receive 80 shares and no cash. The anomaly results from the different tax treatment Revenue Ruling 75-83 would give to the cash A receives during reorganization depending only on which corporation survives. If X merges into Y, A gets 90 shares of Y stock and $10 cash for his 100 shares of X stock. B has his original 80 shares. In this case A has a $10 dividend under 75-83 because $10 is treated as a redemption *before* the exchange which has no effect on A's 100 percent ownership of X so A will not qualify for capital gains treatment under § 302(b)(2).

However, if Y merges into X, A will get 10 shares of X stock and $10 cash for his 20 shares of Y stock and B will get 80 shares of X stock for his 80 shares of Y stock. A will be accorded capital gains treatment for his $10 cash because under 75-83 his percentage ownership in Y before the reorganization has dropped from 20 percent (20 of 100 shares) to 11 percent (10 of 90 shares) thereby qualifying this distribution for capital gains treatment as being a substantially disproportionate redemption. The effect upon A and B of either merger is exactly the same interest in the surviving corporation although 75-83 would treat the cash exchange differently. Levin, Adess, McGaffey, *supra* note 21 at 296-99.

66. It is of interest to note that if one applies the Commissioner's rulings to determine dividend equivalency by reading §302 in *pari materia* with §356(a) that earnings and profits should *not* be considered in determining whether or not a distribution is a dividend but whether a transaction by its nature may properly be characterized as a sale of stock by the redeeming shareholders to the corporation. S. REP. No. 1622, 83d Cong., 2d Sess. 234 (1950).

67. In many cases it will be practically impossible to determine during a reorganization from which treasury the funds for the boot had come if both acquiring and acquired corporations had sufficient funds. Further, without the reorganization the boot would never have been distributed. Finally, even if the acquired corporation had the funds it would not generally have used the money for this purpose absent reorganization.

68. 213 F.2d 914 (6th Cir. 1954).

and accompanying Revenue Ruling 55-745,[69] the Service dealt with a case involving a corporation which was wholly owned by one individual. The taxpayer sold part of the stock to a third person and then caused the corporation to redeem the remainder. Revenue Ruling 55-745 and the court held that in determining treatment of the money paid by the corporation, the transaction must be viewed as a whole.[70] A subsequent Revenue Ruling concluded that *Zenz* is correct in its application of the step transaction doctrine in that ownership interests should be determined after the transaction is complete.[71]

In this same line is the case of *McDonald v. Commissioner.*[72] In this case, taxpayer's corporation, of which he owned ninty-one percent of the outstanding common stock and one hundred percent of the preferred, redeemed all his preferred stock in preparation for an acquisitive reorganization. He then exchanged his voting stock for similar stock in the acquiring corporation. Although the Commissioner argued to the contrary, the Tax Court held that the redemption and sale were part of an overall plan and treated his gain on the redemption as capital gains.[73] In Revenue Ruling 75-360, the Service conceded the appropriateness of the decision in *McDonald.*[74] In view of preceding case law, economic reality, and the Service's Revenue Rulings it is submitted that Revenue Ruling 75-83 is inaccurate in artificially segmenting a single continuous transaction. The *McDonald* and *Wright* cases and Revenue Rulings 55-745, 75-447 and 75-360 appear to correctly interpret the step transaction doctrine and the proper manner of its application to reorganization.[75]

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69. 1955-2 C.B. 223.

70. If this were not the case then the redemption of stock by the owner will not, when viewed separately, substantially reduce his interests in the corporation as required for capital gains treatment under §302(b)(2) since he will still own the same percentage of the corporation as he did before the redemption.

71. "[T]he *Zenz* holding requires that effect be given only to the overall result and proscribes the fragmenting of the whole transaction into its component parts . . . [Therefore] the computation of the voting stock of the corporation owned by the shareholder *immediately after* the redemption for purposes of section 302(b)(2)(C)(i) should be made after the whole transaction is consummated." Rev. Rul. 75-447, 1975-2 C.B. 113.

72. 52 T.C. 82 (1969).

73. The taxpayer received the same tax treatment as did the taxpayer in *Wright.* The *McDonald* approach was cited with approval in Jones v. United States, 72-1 U.S.T.C. ¶9349 (D.N.J. 1972).

74. "Before the Tax Court [in *McDonald]* the Commissioner incorrectly treated the redemption . . . and exchange of . . . stock as separate transactions . . . . The Tax Court correctly found a single integrated transaction." 1975-2 C.B. 110.

75. *Accord,* Levin, Adess & McGaffey, *supra* note 21.

VI. Conclusion

If the aforementioned conclusion is correct, then it appears both *Shimberg* courts were mistaken in their application of the step transaction doctrine. The district court found a meaningful reduction in the taxpayer's interests by comparing his percentage interest in the acquired corporation before reorganization to his interest in the resulting corporation after reorganization.[76] The circuit court was correct in rejecting this determination as leading to boot being accorded favorable tax treatment anytime a larger corporation absorbs a smaller one.

Unfortunately the circuit court seems to have also misapplied the step transaction doctrine by following the same artifical bifurcation of an ongoing single transaction as advocated in Revenue Ruling 75-83. As noted above, this does not seem to be a reasonable nor well founded view. Certainly in the instant case, where cash and stock exchanged hands simultaneously, it stretches credulity to account for the boot as a distribution by LSC to its shareholders prior to the exchange. The court itself states that there is no question that the boot was distributed as part of an overall plan of corporate reorganization.[77]

Finally, the court notes that "it cannot be said that LSC was unable to pay a dividend; rather, for reasons not revealed in the record, it chose not to do so."[78] However, in the same paragraph the court says that ". . . the corporation had only $147,000 in cash on hand when the merger took place."[79] The earnings of the corporation were obviously not available for a dividend by the court's own observation. Since they were tied up in certain aspects of the corporation's business operation they may have never become available for a dividend. There is no legal requirement that mandates a dividend distribution as opposed to use of such earnings and profits to increase capital assets raising the value of the corporation as a whole.[80]

Counsel for the taxpayer has filed for a writ of *certiorari*. It is suggested that the *Shimberg* case should be decided by applying the step transaction doctrine as detailed in Revenue Ruling 75-360 in conjunction with the application of section 302 tests for dividend equivalency read in *pari materia* with section 356. Under such a determination, a comparison of the difference between the amount of stock Shimberg did receive and the

76. 415 F. Supp. at 836.
77. 577 F.2d at 290, n. 17.
78. *Id.* at 289.
79. *Id.*
80. *See* note 67 *supra.*

amount he would have received had he not received any boot (i.e. the number of shares he received plus the number of shares represented by $417,449 worth of MGIC stock) will indicate if the boot, as a constructive redemption of MGIC stock, would meaningfully reduce his interest in MGIC.[81]

Following the method advocated above, the "boot" in the instant case would represent the proceeds of a constructive post-closing redemption. This constructive redemption would reduce Shimberg's ownership of MGIC stock below 80% of his preredemption holdings. The reduction qualifies him for capital gain treatment under section 302(b)(2)'s substantially disproportionate redemption clause.[82]

Stephen Lee Dalton

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81. *Cf.* note 43 *supra.* (This may only be a frying pan-into-fire solution in view of the uncertainty as to what constitutes a meaningful reduction).

82. The exchange in the instant case may be reconstructed as follows. Taxpayer received 21,461 shares in the merger. His boot of $417,449 represents 7,154 more shares of MGIC stock at the market price at the time of the merger ($58.35) for a total of 28,615 shares constructively held by the taxpayer. MGIC had 6,236,580 shares of stock issued and outstanding at the time of the merger. The total boot to LSC of $625,000 represents an additional 10,711 shares for a total of 6,247,291 shares constructively issued and outstanding. Taxpayer's percentage interest in the corporation was .485%. A constructive postclosing redemption of taxpayer's stock reduces both his holdings and the number of shares outstanding by 7,154. The resulting percentage of the taxpayer's interest in MGIC would be .3441%. This is a reduction to less than 80% of the taxpayer's pre-redemption interest in MGIC. The taxpayer does not hold 50% of the voting stock in MGIC and, therefore, qualifies for capital gain treatment. Brief for Appellee, at 24 n. 8, Shimberg v. United States, 577 F.2d 283.