STOCKHOLDER REALIZATION OF CORPORATE EARNINGS
AND THE INCOME TAX

The rate discrimination between capital gains and ordinary income and the phenomenon of the corporate entity result in unsolved problems of inequity and avoidance in federal income taxation of individual shareholder’s realizations of corporate earnings. The shareowner’s tax too frequently depends upon the manner in which he receives his corporation’s earnings, rather than upon the amount of earnings he receives. The stockholder’s undivided interest in accumulated corporate profits may be converted into cash in his hands in one or more steps involving any of several transactions. These transactions may be
roughly classified as: (1) cash and property dividends, (2) sales of stock by shareholders, (3) complete liquidations, (4) partial liquidations, (5) recapitalizations, (6) reorganizations involving more than one corporation, (7) exchanges of like kinds of stock, and (8) stock dividends, including stock rights. Apart from tax considerations, in nearly every situation the employment of either of two or more of the means enumerated will produce substantially the same result to the stockholder. The result to the shareholder can be the same in terms of receipts of cash representing realization of corporate profits, retention of proportionate interest in assets and future earnings of the corporation, and maintenance of control of the corporation. Inequity is present wherever substantially similar tax results do not also follow, regardless of the method employed. Avoidance is invited wherever a shareholder or group of shareholders can choose, on the basis of differing tax consequences, among various methods of effecting the same economic result. Consequently, in converting corporate profits into shareholders' receipts, avoidance is accomplished chiefly in closely held corporations, where the stockholders' potential tax liabilities are most likely to direct the corporation's transactions. Even as among closely held corporations, there may be inequity in that shareholders' avoidance opportunities may depend upon the fortuitous circumstance of capital structure complexity.

The immediate tax result in transactions leading to realization of corporate profits is a legislative or judicial determination that the transaction is a taxable dividend or that it is a capital adjustment. This decision may determine in whole or in part the ultimate tax result in respect to the shareholder's investment. The ultimate tax result is the answer to two questions: (1) whether the corporate profits realized will be taxed to the shareholder at ordinary income rates or at capital gain rates or not at all; (2) whether or not the taxpayer will be able to choose the year or years in which the profits realized are taxed to him, so as to make the most of varying rates and fluctuating income. The significance of these questions to the stockholder underlines the inequity and the opportunity for avoidance involved if transactions with a similar economic effect on the tax-

1 The terms "complete liquidations" and "partial liquidations" here refer to liquidations of corporations rather than of stockholders' investments.

2 This type of reorganization is not considered in the comparisons made in this note.

3 From the viewpoint of the corporate enterprise, less relevant here, a choice among two or more of the transactions listed will often be available to produce a similar result with no controlling nontax considerations favoring a particular alternative. The nontax considerations may be relatively unimportant or balanced in advantages and disadvantages among alternatives. To the extent that a given shareholder controls the corporation's choice, opportunity for avoidance is present if tax effects do not change with changing economic effects to the shareholder. When a shareholder does not control the corporation's choice because of his lack of control of the corporation or because the choice is dictated by nontax influences, inequity remains if, as between him and other taxpayers whose corporations employ other methods, similar economic results occasion different tax results.

payer result in differing tax effects. The following inquiry will show that they often do.\textsuperscript{5}

The shareholder's interest in the accumulated earnings\textsuperscript{6} of his corporation may be changed into cash in one step or several. The simplest one-step means of realization are cash dividends and sales of stock to other stockholders or to strangers to the enterprise. The tax consequences of these transactions are well settled, but the difference in consequences is not an entirely reasonable difference. Thus, the holder of shares which have increased in market value since acquisition because of the accumulation of earnings by the corporation may realize the increment in his investment through the sale of his stock, altogether or a share at a time, at capital gain rates.\textsuperscript{7} But if he realizes his interest in corporate earnings through the receipt of cash dividends, which, of course, have an effect similar to that produced by a sale of shares one at a time, the tax will be at ordinary income rates.\textsuperscript{8} This difference in tax treatment cannot be defended by pointing to stockholders who cannot or will not sell their shares. Possible limits on marketability do not exist in many cases—for example, when the stock is listed on an exchange. The interest of some stockholders in control can not be used as an argument when, for instance, the stock is nonvoting common. The desire of some shareholders to retain their investment in a given enterprise does not justify favoring speculators over stable investors. Moreover, even granting the frequent presence of these deterrents to the sale of shares, the force of the argument based upon them is dissipated at its only possible point of application—when the sale is made. Nor is the sharpness of the tax distinction between cash dividends and sales of stock significantly modified by the market, for it is highly unlikely that the sale price of the shares will often reflect the seller's tax savings in even a roughly commensurate adjustment downward.\textsuperscript{9}

Even though the bargain rates on capital gains are preserved in other areas, their retention in the field of shareholder realizations of corporate profits does not clearly follow. Gain on the sale of land may result from inflation, the development of the surrounding area, or many other factors, but it will include no element of past earnings from the productive use of the land. Gain on the sale

\textsuperscript{5}The comparisons which follow assume that the corporation involved is a relatively normal enterprise actually engaged in business activities. Problems involving personal holding companies, corporations established solely for tax purposes, sales of property by a sole stockholder to his alter ego to take a loss, and other abuse of the corporate entity are not within the scope of this note.

\textsuperscript{6}"Earnings or profits" problems are not here discussed. Each example supposes a corporation with "earnings or profits accumulated after February 28, 1913, or . . . earnings or profits of the taxable year," Int. Rev. Code § 115(a), 26 U.S.C.A. § 115(a) (1945), sufficient to cover the distribution in question, or that the corresponding requirements in Int. Rev. Code § 115(a) or § 112(c)(2) have been met.


\textsuperscript{8}Int. Rev. Code §§ 22(a), 115(a), 26 U.S.C.A. §§ 22(a), 115(a) (1945).

\textsuperscript{9}Not only because of the lack of buyers (and sellers) informed as to the tax consequences of particular sales of stock, but also because the seller's tax saving is not necessarily the buyer's tax loss. Text at notes 91–94 infra.
of corporate shares, on the other hand, will very often represent past undistri-
bututed profits from the productive use of the capital symbolized by the stock. The
interposition of the corporate entity permits the easy transformation of operat-
ing profits (including rent) into capital gains for the stockholder. This feat is
not readily accomplished by the owners of other capital assets. The tax dif-
ference between cash dividends and sales of stock is doubly anomalous, for it
involves not only the present system's general discrimination between capital
gains and ordinary income, but also the opportunity to change normal, re-
curring profits into capital gains. Since these two transactions are the poles be-
tween which other shareholder realizations appear, the possible futility of any
attempt at substantial equity as to the intermediate types, or at establishment
of a workable set of rules for them, is suggested at once.10

From the stockholder's viewpoint, the complete liquidation of a corporation
is very much like a sale of his stock, and it is so treated, the stockholder conse-
cquently realizing only a capital gain, regardless of the amount of accumulated
profits thereby distributed to him.11 The comparison between complete liquida-
tion and cash dividends is obvious enough, and has resulted in the collapsible
corporation, organized in anticipation of liquidation and resultant shareholder
realization of profits without dividend taxation.12 Even when this phenomenon
is disregarded, little justification appears for the contrast in tax results—be-
tween liquidation and cash dividends—in the case of a normal corporation com-
ing to a natural end, unless it be the law's lack of an effective averaging sys-
tem.13 The difference between capital gains and ordinary income still depends

10 However, there may still be some value in drawing the line at approximately the same
place in each of the intermediate cases.

11 Int. Rev. Code § 115(c), 26 U.S.C.A. § 115(c) (1945). Nor does Section 115(g) (text at
liquidation will often involve a series of distributions over a period of more than one taxable
year. There is conflicting authority as to how the gain or loss should be computed, but the
method apparently preferred is the application of each distribution against the stockholder's
aggregate basis, with no gain recognized until the total basis has been exhausted, irrespective
of the stockholder's surrender of a few shares at the time of each distribution. Alvina Ludorff,
40 B.T.A. 32 (1939) (rejecting taxpayer's attempt to use installment basis as in installment
sales); Florence M. Quinn, 35 B.T.A. 412 (1937) (rejecting computation of gain or loss on each
distribution on basis of shares turned in). Contra: Courtenay D. Allington, 31 B.T.A. 421
(1934).

12 Such as the one-movie corporation. See Armstrong, Shall We Have a Clifford Doctrine for
Corporations?, 24 Taxes 830 (1946). The chameleon type of enterprise, which may make sev-
eral successive changes from corporation to partnership and back again, may be somewhat
deterred by the possible inclusion of good will value in determining the gain on corporate
liquidation. Shelton, Stockholder's Gain on the Liquidation of a Corporation When There Is
Good Will, in New York University Seventh Annual Institute on Federal Taxation 349 (1949).

13 This might be argued as a possible justification for the result in the case of sales of stock
also, and, indeed, for the entire capital gains section. But the argument is much less a justifica-
tion for this discrimination than an admission that such an averaging system is required.
Moreover: "With the six-months holding period in effect, there is no basis for the argument
that the special treatment of capital gains is a substitute for the averaging of income received
over a period of years." Blough, Where Is the Income Tax Heading?, in New York University
Seventh Annual Institute on Federal Taxation 800, 803 (1949).
upon whether the earnings of the enterprise have been distributed or accumulated prior to the liquidation. The rewards for liquidating are even more alluring when one considers the possibility, through distributions in kind, of avoiding tax to the corporation on the sale of capital assets which have increased in value during corporate ownership, 14 with the possible added touch of converting potential profits to the corporation on inventories or contracts into mere capital gains for the shareholders. 15

Stock redemptions ("partial liquidations" in the language of the Code) 16 may resemble either cash dividends or complete liquidations in their economic effect on the shareholder. If the stockholder’s ownership interest in the corporation is entirely terminated by the redemption, he is in a position similar to that of one who has sold all of his shares. If stock has been redeemed pro rata among all the stockholders, so that the proportionate interest of each in the assets and earnings of the corporation is unchanged, the effect can hardly be distinguished from that of a cash dividend. Accordingly, in the former situation the taxpayer will be treated as though he had sold his shares, 17 while in the latter case he will generally be considered as having received a taxable dividend. 18 If the basic simi-

14 If the corporation sells the assets and then distributes the proceeds to the stockholders (in liquidation), the corporation will be taxed on the capital gain resulting from the excess of the selling price over the basis of the assets to the corporation, and the stockholders will be taxed on the capital gain resulting from the excess of the amount received in liquidation over the basis of their shares. If the corporation distributes the assets in kind to the stockholders, and the stockholders then sell the assets, the tax to the corporation is avoided. But negotiations prior to the liquidation may nevertheless result in the imposition of both levies. Comm'r v. Court Holding Co., 324 U.S. 331 (1945); The Liquidation of Corporate Ownership Interests—A Federal Tax Problem, 14 Univ. Chi. L. Rev. 647 (1947); Freeland, Recent Trends in the Court Holding Company Principle, in New York University Seventh Annual Institute on Federal Taxation 369 (1949).

15 Income in 1943 from oil brokerage contracts, which had no ascertainable fair market value when received in complete liquidation of a corporation in 1942, was held to be long term capital gain in Comm'r v. Carter, 170 F. 2d 911 (C.C.A. 2d, 1948). This suggests transactions like the following one: A corporation, about to be liquidated, holds large inventories, the sale of which would result in income to the corporation which would not be subject to the capital gains limitation in Int. Rev. Code § 117(a)(1). If the inventories are sold for a percentage of the future profits of a successor enterprise or for some other contingent consideration, the consideration may have no ascertainable market value at the time of the sale or at the time of the liquidation. It may therefore be possible to eliminate the corporate tax and to spread the stockholder’s gain on the liquidation. Brodsky, Planning Business Transactions to Produce Capital Gains, in New York University Seventh Annual Institute on Federal Taxation 302, 306-309 (1949), But cf. Jud Plumbing & Heating, Inc. v. Comm'r, 153 F. 2d 681 (C.C.A. 5th, 1946) (construction contracts).

16 The Code defines a distribution in partial liquidation as "a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock." Int. Rev. Code § 115(f), 26 U.S.C.A. § 115(f) (1945). "[O]ne of a series of distributions in complete cancellation or redemption of all . . . of [a corporation’s] stock" could be more aptly described as part of a complete liquidation, and it is so treated, not being subjected to Section 115(g). Treas. Reg. 111, § 29.115-9 (1946).


larity between the seller of shares and the recipient of a cash dividend (as to realization of corporate earnings)\(^9\) is disregarded, these two cases are easily understandable. When the analogies are not so clear, it becomes more difficult to apply the partial liquidation sections of the statute, which provide in Section 115(g) that where the redemption is effected "at such time and in such manner as to make . . . [it] in whole or in part essentially equivalent to the distribution of a taxable dividend," it will be so treated.\(^20\) As might be expected, the courts have used a variety of criteria, sometimes conflicting, in applying this provision.\(^21\) Perhaps the most important factor pointing toward the analogy of a complete liquidation has been a definite contraction of the business of the corporation which resulted in the redemption of shares.\(^22\) The wavering line thus drawn

\(^9\) Text at notes 7–10 supra.
\(^{10}\) Int. Rev. Code § 115(g), 26 U.S.C.A. § 115(g) (1945).

The absence of a precise pro rata distribution will not avoid dividend treatment. W. & K. Holding Corp., 38 B.T.A. 830 (1938); James D. Robinson, 27 B.T.A. 1018 (1933), aff'd 69 F. 2d 972 (C.C.A. 5th, 1934). Nor can the section be avoided by holding the shares in the corporate treasury. Cancellation is not a prerequisite. Wall v. United States, supra, at 465; James D. Robinson, supra. But cf. Comm'r v. Snite, 177 F. 2d 819, 823 (C.C.A. 7th, 1949). The absence of a plan on issuance of the shares to redeem them later in avoidance of dividend taxation will not prevent the application of Section 115(g). Kirschenbaum v. Comm'r, supra, at 24 (overruling prior cases); Smith v. United States, 121 F. 2d 692, 695–696 (C.C.A. 3d, 1941); Stein v. United States, supra, at 573. But if the redemption was dictated by the needs of the corporate business, it will probably escape dividend treatment. Fred B. Snite, 16 T.C. 523 (1948), aff'd Comm'r v. Snite, supra (stock purchased by corporation for transfer to employees who sought interest in business); Samuel A. Upham, 4 T.C. 1120 (1945) (plan to eventually liquidate corporation and turn over business to employees); Georgia P. Johnson, 6 T.C.M. 633, 641 (1947); cf. cases cited note 22 infra. It has been suggested that "perhaps the section covers all cancellations or redemptions which result in the distribution of accumulated earnings." Kirschenbaum v. Comm'r, supra, at 24. But this is, at least as yet, not the case. Comm'r v. Snite, supra, at 822. In general, see Gutkin and Beck, Stock Redemptions as Taxable Events Under Section 115(g), 24 Taxes 1172 (1946); Crown, Essentially Equivalent to the Distribution of a Taxable Dividend, 25 Taxes 146 (1947).

\(^{22}\) Comm'r v. Babson, 70 F. 2d 304 (C.C.A. 7th, 1934), cert. den. 293 U.S. 571 (1934); Joseph W. Inler, 11 T.C. 836 (1948); Samuel A. Upham, 4 T.C. 1120 (1945); Heber Scoycroft Investment Co., 4 T.C.M. 755 (1945); Danzig, Distributions in Liquidations and Reorganizations, 26 Taxes 645 (1948). On the other hand, the absence of a shrinkage in the business of the corporation in correspondence with the redemption has been a significant factor toward holding the redemption taxable as a dividend. Rheinstrom v. Conner, 125 F. 2d 790 (C.C.A. 6th, 1942), cert. den. 317 U.S. 654 (1942); Flanagan v. Helvering, 116 F. 2d 937 (App. D.C., 1940); Stein v. United States, 62 F. Supp. 568 (Ct. Cl., 1945); United National Corp., 2 T.C. 111 (1943).
between taxable dividends and capital adjustments is, in general, defensible once the basic premises—the differing tax consequences of cash dividends and sales of stock—are granted. But the legal structure built around Section 115(g) may be entirely forgotten if a subsidiary is available, for, by recent Tax Court construction, the section does not apply to a subsidiary corporation’s purchase of its parent’s stock from the parent’s owners. Therefore, until the law is changed, stockholders of a parent corporation may convert their interests in corporate earnings into cash at will by simple sales of stock to the subsidiary. These sales may be made without regard to the presence or absence of a shrinkage in the corporate activities of either parent or subsidiary and with no change in the stockholders’ proportionate interests in the parent. And their receipts will be partly taxable at capital gains rates and partly untaxed at the time. Moreover, the untaxed portion, which reduces the basis of the stockholder’s remaining shares, need never be subjected to an income tax unless the parent corporation is forced to liquidate. The possible removal of the parent-subsidiary gap in Section 115(g) suggests a similar, but perhaps less vulnerable, avoidance system. If entirely separate corporations are owned in substantially the same proportions by identical stockholders, either corporation may purchase a given fraction of the holdings of each stockholder in the other corporation without coming within Section 115(g). The stockholders may thus indefinitely withdraw the profits of both corporations without dividend taxation. Although this plan may frequently be impractical, and although it might be checked by judicial maneuvering, it again implies: (1) that there will always be a lag between taxpayers’ avoidance plans and judicial avoidance-prevention doctrines, and consequently ever-present avoidance, until the Code is basically changed;

If the basic premises require further examination, suppose A invests $1,000 in the A Corp. on the same day B invests $1,000 in the B Corp. After five years, the A Corp., with accumulated profits of which A’s pro rata share is $1,000, terminates half its operations and partially liquidates, redeeming one-half A’s stock for which A is distributed $1,000. At the same time the B Corp., with accumulated profits in which B’s proportionate interest is $1,000, distributes cash dividends, of which $1,000 go to B. A has a long-term capital gain of $250 and the basis of his remaining shares is $500. B has ordinary income of $1,000 and the basis of his shares remains $1,000. If both corporations later completely liquidate without further earnings or losses, A has another long-term capital gain of $250, while B has no taxable gain. If both corporations continue operations with equal success, so that A’s shares have the same market value at his death as have B’s at his decease, the respective successors of each begin their ownership with the same bases.

The section reads: “If a corporation cancels or redeems its stock....” The court relied on the words “its stock.”

Congressional change is suggested by the Tax Court “[i]f we are mistaken in our view of [Section 115(g)]’s scope,...” Ibid. Judicial change is suggested by the Commissioner’s announcement of nonacquiescence. Internal Revenue Bulletin 1949-7, 5 C.C.H. Fed. Tax Rep. ¶ 67205 (1949).


and (2) that the basic discrepancy between the tax on a sale of shares and the tax on a dividend must be removed before substantial fairness can be attained, for the plan described would achieve its effectiveness because of its similarity to an ordinary sale of stock by the shareholders.

If a corporation reduces the par value of each of its shares by, for instance, fifty per cent and distributes the amount of the reduction to the shareholders, the effect on a shareholder (or on the corporation) is very difficult to distinguish from that resulting if the corporation redeems one-half its shares pro rata from its stockholders at par value. However, the shareholder may find that there is a considerable distinction between these two transactions when he pays his income tax. The distribution from “reduction surplus” will be wholly taxable as a dividend, whether or not the reduction of par was accompanied by or resulted from a contraction in business. The stock redemption distribution will be taxed as a capital gain and only to the extent that it exceeds the basis of the stock turned in, if it qualifies as a partial liquidation by reason of a corresponding shrinkage in the activities of the corporate enterprise. The attempt to draw a line between shareholder receipts resembling cash dividends and receipts resembling those from the sale of stock is here reduced to a narrow difference in formalities.

Contrasting tax consequences in transactions with the same nontax effect may of course appear in loss situations as well as in circumstances in which the investment is profitable. A comparison of partial liquidations and recapitalizations involving cash payments to shareholders will furnish an example. If the stockholder exchanges shares with the corporation, trading ten no-par shares which cost him $100 each for five $10 par shares worth $17 each and $85 in cash, the transaction will probably be considered a recapitalization, and no loss will be recognized to the shareholder. If, instead of exchanging shares, he turns in five

Sheehan v. Dana, 163 F. 2d 316 (C.C.A. 8th, 1947); Beretta v. Comm'r, 141 F. 2d 452 (C.C.A. 5th, 1944), cert. den. 323 U.S. 720 (1944); see R.D. Merrill Co., 4 T.C. 955, 967 (1945). There will, of course, be no dividend tax if the reduction in par is one of a series of such reductions constituting a complete liquidation of the enterprise. R. D. Merrill Co., 4 T.C. 955, 963-71 (1945).

Joseph W. Imler, 11 T.C. 836 (1948); Samuel A. Upham, 4 T.C. 1120 (1945).

Compare cases cited note 28 supra with cases cited note 29 supra. In each of these cases there was no change in the proportionate interests of the stockholders; in each of them there was a definite termination of a substantial part of the corporation's business. In the Beretta opinion (a reduction of par case) the court said: “A corporation may not completely avoid tax consequences to its stockholders by declaring a stock dividend out of profits in one year, later reducing its capital stock by the amount of such stock dividend, and then distributing, as capital assets, these profits under the guise of a partial liquidation.” Beretta v. Comm'r, 141 F. 2d 452, 455-56 (C.C.A. 5th, 1944). But it appears that precisely this could have been done if the corporation had only collected a few pieces of paper from the stockholders. Cases cited note 29 supra; authorities cited note 22 supra. Even this distinction is usually not present since new share certificates reflecting the change in par value will ordinarily be issued, the old certificates being turned in.

Spirella Co. v. Comm'r, 155 F. 2d 908 (C.C.A. 2d, 1946); Int. Rev. Code §§ 112(b)(3), 112(g)(1)(E), 112(e), 26 U.S.C.A. §§ 112(b)(3), 112(g)(1)(E), 112(e) (1945). If the transaction
of the no-par shares for retirement and receives $85 in cash, keeping the other five no-par shares which are now worth $17 each, he will be allowed a capital loss of $415, since this transaction is a partial liquidation.32 Moreover, if the corporation directors wish to change the remaining shares from no-par to $10 par, this may be done later without tax consequences.33 If the second step follows or precedes the liquidation step too closely, the two steps may be consolidated into one transaction in judicial contemplation.34 Such a decision most clearly spotlights the strange distinction, and suggests the significant although perhaps unintended influence of the structure of the Code. The lack of correlation between Section 112 (dealing with exchanges) and Section 115 (dealing with distributions) is apparent in this and other situations where formal differences in essentially similar transactions place one transaction within the former section and another within the latter, with strikingly dissimilar tax results. The easily demonstrated but often overlooked practical identity of some exchanges with some distributions tends to be obscured by the deceptive separateness of the relevant Code sections. When a court recognizes the similarities in such instances the only means of reconciliation of the sections is often a case-to-case technique like that of the consolidation of two transactions. A broader reconciliation can be effected by applying the Section 115 definition of a dividend35 to Section 112 as well as to other parts of Section 115. This method, introduced by the Supreme Court,36 eliminates some of the inconsistencies, although it introduces others.37

In profitable investments, recapitalizations in which the shareholder receives cash again appear unfavorable to him as compared with stock redemptions. If the corporation has accumulated profits, the stockholder, in a recapitalization, is held to be a recapitalization within Section 112(g)(1)(E), and therefore a reorganization within Section 112(b)(3), no loss will be recognized even though "boot" is included in the exchange, under Section 112(e).38 Malone v. Comm' r, 128 F. 2d 967 (C.C.A. 5th, 1942); Kelly v. Comm' r, 97 F. 2d 915 (C.C.A. 2d, 1938). In the Malone case the redemption price per share was less than market value, but the court did not think the artificial nature of the loss was a valid objection to the partial liquidation conclusion.


34Spirella Co. v. Comm' r, 155 F. 2d 908 (C.C.A. 2d, 1946). The contrasting results in the cases described in the text are significant even though the stockholder who takes the capital loss in the partial liquidation must make a corresponding basis adjustment, since he has an advantage in timing which is especially important in view of the limitation on capital loss allowance. Int. Rev. Code § 117(d)(2), 26 U.S.C.A. § 117(d)(2) (1945). Moreover, he might otherwise lose entirely the benefit of this capital loss. Int. Rev. Code § 113(a)(5), 26 U.S.C.A. § 113(a)(5) (1945).


37For example, the inconsistency described in text at notes 38-43 infra.
will probably receive property worth more than the cost of his old shares. This gain will be recognized to the extent that he receives money\textsuperscript{38} in the exchange.\textsuperscript{39} The amount of gain recognized will nearly always be taxed as a dividend.\textsuperscript{40} On the other hand, the money received in a partial liquidation, with no accompanying exchange of shares for shares, will be partly taxed as a capital gain and partly accounted for as an adjustment of basis,\textsuperscript{41} unless the redemption is held subject to Section 115(g).\textsuperscript{42} The shallow foundation for this tax distinction is emphasized by analogous cases in which the stockholders, wishing to discontinue a part of the business of their corporation, could have turned in a comparable part of their stock, their consequent realization of corporate profits being taxed as a capital gain on a distribution in partial liquidation. Instead, they caused the corporation to exchange a part of its assets for the stock of a new corporation, and then completely liquidated the old corporation. These two transactions were considered by the court to be a single integrated proceeding which was held to be a reorganization, and the realization of corporate earnings was taxed as a dividend.\textsuperscript{43} However, the tax distinction between partial liquidations and recapitalizations described above may disappear. The leading case taxing the "boot" received in a recapitalization as a dividend\textsuperscript{44} has been followed by suggestions of judicial inclination to tax every distribution in partial liquidation as

\textsuperscript{38} Or other property not permitted by Section 112(b)(3) to be received without recognition of gain.


\textsuperscript{40} Comm'r v. Estate of Bedford, 325 U.S. 283 (1945); Int. Rev. Code § 112(c)(2), 26 U.S.C.A. § 112(c)(2) (1945); cf. Estate of Elise W. Hill, 10 T.C. 1090 (1948) (reorganization involving two corporations). The language of the Court in the Bedford case seems to make every money distribution of earnings in a recapitalization (or other reorganization) taxable as a dividend to the extent of the gain recognized in Section 112(c)(1). Thus, "we hold that a distribution, pursuant to a reorganization, of earnings and profits 'has the effect of a distribution of a taxable dividend' within § 112(c)(1)." Comm'r v. Estate of Bedford, supra, at 292. However, it has been suggested that this language was broader than necessary or intended, and that it should be limited by the words of Section 112(c)(2) which, if the distribution "has the effect of a distribution of a taxable dividend," tax as a dividend "such an amount of the gain recognized under [Section 112(c)(1)] as is not in excess of [the distributee's] ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913." (Italics added.) Thus, if a preferred stockholder exchanges his 5% preferred share with a $100 liquidation preference for a 4% preferred share with a $100 liquidation preference and $10 cash, there being no dividend arrearages on the old shares, the cash is paid to compensate for the reduction in dividend and liquidation preferences. The cash received might be considered to be "in excess of [the stockholder's] ratable share" of earnings, since the preferred stockholder whose dividends have been paid may be said to have no ratable share in the corporate earnings. Darrell, The Scope of Commissioner v. Bedford Estate, 24 Taxes 266 (1946).

\textsuperscript{41} "[A]mounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock." Int. Rev. Code § 115(c), 26 U.S.C.A. § 115(c) (1945).

\textsuperscript{42} Authorities cited notes 20–22 supra.

\textsuperscript{43} Lewis v. Comm'r, 176 F. 2d 646 (C.A. 1st, 1949); Estate of Elise W. Hill, 10 T.C. 1090 (1948).

\textsuperscript{44} Comm'r v. Estate of Bedford, 325 U.S. 283 (1945).
a dividend to the extent of the accumulated corporate earnings. But this result hardly seems proper as a matter of interpretation of the present statute, and the distinction still remains.

All of the transactions so far discussed involved one-step realizations of cash by the stockholder. If a recapitalization does not include a money distribution, a second step is required if the shareholder is to convert his interest in corporate profits into cash. A shareholder in a corporation with widely owned stock can, of course, realize the increment in his investment as a capital gain through a sale of his stock, and he may repurchase similar shares later if he desires. In a corporation with only closely held common shares outstanding, however, the stockholder may be unable to market his stock at its real value; moreover, he may not wish to disturb his proportionate interest in the enterprise. The sale of bonds by the shareholder would avoid or lessen both these objections. A dividend in bonds has long been taxable to the stockholder at the market value of the bonds; so recapitalizations involving an exchange of common for bonds have been used to provide stockholders in closely held corporations with bonds to sell and a consequent opportunity to realize on accumulated corporate earnings at capital gain rates. Such a recapitalization is within the terms of the reorganization non-recognition provisions, falling under Section 112(b)(3). These provisions were intended to eliminate tax barriers to economically desirable changes in cor-

46 See Kirschenbaum v. Comm'r, 155 F. 2d 23, 24 (C.C.A. 2d, 1946), cert. den. 329 U.S. 726 (1946); but cf. Comm'r v. Snite, 177 F. 2d 819 (C.A. 7th, 1949). This tendency, to apply Section 115(g) to partial liquidations in the same manner as Section 112(c)(2) is applied to recapitalization distributions, is furthered by the frequent statement that the net effect of the distribution is the criterion for Section 115(g) application. See, for example, Smith v. United States, 121 F. 2d 692, 695-96 (C.C.A. 3d, 1941).

47 So broad an application of Section 115(g) would render parts of Section 115(c) practically meaningless.

48 No gain is recognized in an exchange of common stock solely for common stock in the same corporation, or in an exchange of preferred solely for preferred in the same corporation, apart from recapitalizations. Int. Rev. Code § 112(b)(2), 26 U.S.C.A. § 112(b)(2) (1945). If money or other property is also received in the exchange, gain is recognized to the extent of the sum of the money and the fair market value of the other property. Int. Rev. Code § 112(c)(1), 26 U.S.C.A. § 112(c)(1) (1945). But Section 112(c)(2), which usually (always?) taxes as a dividend all of the gain so recognized in the case of recapitalizations and other reorganizations (as discussed in the text and note supra) so long as the gain is received from accumulated earnings, is expressly applicable only to reorganization exchanges and impliedly inapplicable to Section 112(b)(2) exchanges. Is the gain received in money in a Section 112(b)(2) exchange always a capital gain and never taxable as a dividend? Why would this result not apply to the reduction of par cases cited in note supra?


40 Int. Rev. Code §§ 112(b)(3), 112(g)(2)(E), 26 U.S.C.A. §§ 112(b)(3), 112(g)(2)(E) (1945). Although Section 112(b)(3) is headed "Stock for stock on reorganization," the section itself states: "No gain or loss shall be recognized if stock or securities . . . are . . . exchanged solely for stock or securities. . . .' Ibid. Exchanges of bonds for bonds have been held to be within this section. Comm'r v. Neustadt's Trust, 131 F. 2d 528 (C.C.A. 2d, 1942); Jeanne G. Miller, 3 T.C.M. 230 (1944); cf. Treas. Reg. 111, § 29.112(g)-2 (1946) (preferred for bonds given as example of recapitalization).
porate capital structures by preventing recognition of "paper profits" in necessary business adjustments. However, the provisions have been extensively used for avoidance, including avoidance of dividend taxation by realization of corporation earnings as capital gains. As a result, the courts have superimposed requirements beyond those expressed by the statute on transactions for which taxpayers seek immunity under Section 112(b)(3), including the requirement that the transaction must have served a business purpose. The requisite business purpose has been held to be a corporate business purpose. The meaning of "corporate business purpose" has never been entirely clear, but the concept apparently requires that a recapitalization benefit the corporate enterprise, apart from the stockholders, in ways unrelated to tax considerations, if the shareholder is to escape taxation of his gain on the exchange. The "corporate" refinement has been vanishing since the Supreme Court decision in Bazley v. Comm'r, so it is probably no longer necessary to be concerned with this subtlety in the business-purpose concept. In that decision, the shareholder's gain in a recapitalization exchange of common stock for bonds was held taxable as a dividend, in an opinion which implied that in any reorganization having an effect equivalent to a distribution of earnings the stockholder may be held to be the taxpay er.


56 The requirement of a continuity of proprietary interest on the part of the taxpayer after the exchange has been applied in reorganizations involving more than one corporation. Pinellas Ice & Cold Storage Co. v. Comm'r, 287 U.S. 462 (1933); Le Tulle v. Scofield, 308 U.S. 415 (1940); Int. Rev. Code §§ 112(g)(1)(B), 112(g)(1)(C), 26 U.S.C.A. §§ 112(g)(1)(B), 112(g)(1)(C) (1945). This test has not (yet) been introduced into the recapitalization field. Clarence J. Schoo, 47 B.T.A. 459 (1942).

57 The business-purpose requirement originated in Gregory v. Helvering, 293 U.S. 465 (1935). It has been applied to recapitalizations in cases requiring direct business advantage to the corporation as opposed to benefits to the stockholders. Adam A. Adams, 5 T.C. 351 (1942), aff'd 155 F. 2d 246 (C.C.A. 9d, 1946), aff'd 331 U.S. 737 (1947); Alice H. Bazley, 4 T.C. 897 (1945), aff'd 155 F. 2d 237 (C.C.A. 9d, 1946), aff'd 331 U.S. 737 (1947); Marjorie N. Dean, 10 T.C. 19 (1948); Louis Wellhouse, 3 T.C. 365 (1944).

58 Cases cited note 52 supra. There is "no reliable definition of corporate business purpose... in any case where the court feels that it should hold that there has been a reorganization, there is a corporate purpose; and in any case where the court feels that it should hold no reorganization, corporate purpose is lacking." Ivins, The Business Purpose Rule in Corporate Recapitalization, in New York University Seventh Annual Institute on Federal Taxation 1161, 1165 (1949). See Spear, "Corporate Business Purpose" in Reorganization, 3 Tax L. Rev. 225 (1947).

59 331 U.S. 737 (1947). The corporate business-purpose requirement was expressly repudiated in Lewis v. Comm'r, 176 F. 2d 646 (C.A. 9d, 1949). The Tax Court's retreat from the refinement was not so obvious, but nevertheless clear. Estate of John B. Lewis, 10 T.C. 1080 (1948); Estate of Elise W. Hill, 10 T.C. 1090 (1948).

60 One thousand $100 par shares had been exchanged for five thousand no-par shares and callable ten year debenture bonds with a face value of $400,000. Bazley v. Comm'r, 331 U.S. 737 (1947).
recipient of a taxable dividend. The Court made little mention of the lack of corporate business purpose in the transactions in the Bazley case. The broad language employed in the opinion could be interpreted to establish a new test—equivalence to a taxable dividend. If that is now the test, the shareholder's gain on a recapitalization exchange will be taxed as a dividend to the extent that the securities received would have been so taxed if there had been no exchange, but only a distribution of the securities. Whether or not the business-purpose test is obsolete in the recapitalization field, there is little doubt as to the general direction of the decision or as to its effect on bonds in recapitalizations. The same decision implicitly held that bonds, or at least callable bonds, are not "securities" within the meaning of the reorganization nonrecognition provisions.

With bonds understandably unpopular as securities for which to exchange common stock in recapitalizations when the corporation has accumulated earnings, preferred stock has assumed new importance. The issuance of preferred stock in exchange for common stock has been held to come within the recapitalization provisions, with neither a taxable dividend nor recognized capital gain resulting to the stockholder. Under the present decisions, aside from the possible implications of the Supreme Court's holding in the Bazley case, a business purpose will prevent the recognition of gain on such an exchange.

57 Ibid.
59 Bazley v. Comm'n, 331 U.S. 737, 743 (1947): "And even if this transaction were deemed a reorganization, the facts would equally sustain the imposition of the tax on the debentures under § 112(c)(1), and (2). Commissioner v. Bedford. ..." If the bonds were subject to tax under Section 112(c)(2), the Court must have considered them property not permitted by Section 112(b)(2) to be received without the recognition of gain, and therefore not securities within the meaning of the latter section. The Court had referred to the fact that the bonds were callable at the will of the corporation which was the will of the taxpayer, the corporation being entirely owned by a husband and wife. Hence the implied exclusion of bonds from the definition of "securities" is perhaps limited to the facts present in the Bazley case. Compare cases cited note 49 supra. The Bedford case is discussed in note 40 supra.
60 Bass v. Comm'r, 129 F. 2d 300 (C.C.A. 1st, 1942) (Commissioner's attempt to tax preferred as stock dividend defeated); Marjorie N. Dean, 10 T.C. 19 (1948) (corporate business purpose prevented recognition of gain); Louis Wellhouse, 3 T.C. 363 (1944). The Bass case was not very strict in requiring a corporate business purpose, and it is probably no longer the law, particularly in view of the cases cited at note 56 supra.
61 Cases cited note 52 supra. The only later decision in point distinguished the Bazley case on the grounds that no bonds were involved, the taxpayers did not retain any common stock, and the distribution was not pro rata among the stockholders. Several stockholders did not participate in the exchange. Marjorie N. Dean, 10 T.C. 19 (1948).
the test of equivalence to a taxable dividend is applied as a result of the Bazley decision, a recapitalization exchange of common for preferred will not necessarily be taxed, in the absence of additional circumstances indicating avoidance, since a dividend in preferred on common would not necessarily be a taxable dividend.62 However, since the Bazley decision, the Treasury has indicated that it may attack transactions in which preferred stock is acquired by the common stockholder without tax consequences and then sold or redeemed.63 The government’s chances of success in the courts in this endeavor are problematical,64 as are possibilities of legislative clarification.65

The mechanics of the preferred stock method of realization of corporate earnings as capital gains vary. The preferred may be issued in exchange for a part of the stockholder’s common in a recapitalization or as a stock dividend on common. The preferred may then be sold, redeemed, or sold and redeemed from the purchaser. Where the stock dividend or recapitalization and the sale, redemption, or sale and redemption are close in time and obviously interdependent, they are subject to judicial integration into one transaction to be taxed as a dividend, especially since the Bazley case. Deliberately planned “bail-outs” with manifest avoidance purposes may thus be set apart from the main trends. Apart from these situations, if the preferred is issued as a stock dividend, no showing of business purpose is required to escape taxation of the dividend, and, under the Strassburger decision, it will be taxed only if there is preferred previously outstanding.66 If the preferred stock issuance is part of a recapitalization, where a sufficient business purpose can be found it will be immune from dividend taxation, unless the Bazley case establishes a new doctrine for recapitalizations. If that decision does make equivalence to a taxable dividend the test for recapitalizations,67 issuances of preferred in recapitalizations will be judged according to the Strassburger case. Thus when the stockholder exchanges common for common and preferred in a recapitalization, the preferred received will not be equivalent to a taxable dividend, as defined by the Strassburger decision, unless other preferred is previously outstanding. Both methods are therefore equally

64 Possible approaches in attempts to tax such transactions are analyzed in Platt, Preferred Stock Dividends and Recapitalizations After the Bazley and Adams Cases, in New York University Seventh Annual Institute on Federal Taxation 561 (1949); and in authorities cited note 63 supra.
65 Recent proposals for congressional action tend toward greater exemption and more confusion. For example: H. R. Doc. 523, 80th Cong. 2d Sess., at 22 (1947).
66 A dividend in preferred on common, with only common previously outstanding, was held not taxable in Strassburger v. Comm’r, 318 U.S. 604 (1943). The business-purpose requirement has never appeared in stock dividend cases.
67 Authorities cited note 58 supra.
protected by the *Strassburger* case, a decision unusually vulnerable to discard, but nevertheless representing settled statutory construction. The Treasury's opportunities for dividend taxation at redemption are equally problematical. If the preferred is redeemed from the original recipient, the redemption will probably be taxed under Section 115(g), but if it is redeemed from a purchaser, the redemption will probably not be subject to that section. Therefore, aside from obvious "bail-outs," and in the absence of congressional change or a considerable change in interpretation of present statutes, it is still possible for common stockholders to achieve the effect of a cash dividend in two steps without any corporate liquidation, complete or partial, and without dividend taxation.

It has already been suggested that stock dividends are not subject to the business-purpose requirement, so that a stock dividend in preferred on common may be a more convenient first step than a recapitalization in any attempt to transfer earnings to the stockholder without a dividend tax and without disturbing his interest in the corporation. Under present law, a stock dividend is taxable if it alters the shareholder's pre-existing proportionate interest in the assets of the corporation—that is, his rights upon liquidation and his rights to dividends. Accordingly, where both preferred and common stock are outstanding-

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68 Text at note 62 supra.

69 The Strassburger case was a five to three decision, which might be distinguished on the ground that it involved a corporation with only one stockholder. Several cogent arguments are given for overruling the decision in DeWind, op. cit. supra note 63, at 1142-54. If the case is overruled or its authority confined to one-man corporations, stockholders who were fortunate enough to have included preferred stock in the capital structure of their corporation at organization, and to have taken both common and preferred rather than only common, would still be able to turn their interests in corporate earnings into cash without being taxed as dividend recipients and without loss of control. This is now the case in corporations which originally issued bonds and common to the same investors. Thus the Bazley decision and its possible successors only shift the comparative inequity and place a premium on complex capital structures in closely held corporations.

70 Authorities cited notes 18 and 21 supra.

71 All of the purchaser's shares will probably be redeemed at one time. The Regulations exempt shareholders whose stock is completely redeemed from Section 115(g). Treas. Reg. 111, § 29.115-9 (1946). Even if the purchaser redeemed only a part of his shares, the section might not be applied, since some cases have held purchasers not subject to its provisions. However, most courts would probably not distinguish purchasers from original shareholders in this connection. Shelby H. Curlee, 28 B.T.A. 773 (1933), aff'd sub nom. Randolph v. Comm'r, 76 F.2d 472 (C.C.A. 8th, 1935); cf. United National Corp., 2 T.C. 123 (1943). But cf. Parker v. United States, 88 F. 2d 907 (C.C.A. 7th, 1937).

72 A careful and comprehensive analysis of the cases and the proportionate-interest test may be found in Rottschaefer, *Present Taxable Status of Stock Dividends in Federal Law*, 28 Minn. L. Rev. 106 (1944). A change in voting rights with no change in rights to dividends or rights on liquidation might be a sufficient change in proportionate interests to make a stock dividend taxable. It probably is not—no cases raise the point—and it hardly should be. Ibid., at 128. But see Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. of Pa. L. Rev. 147, 150 (1947).
ing prior to the dividend, a dividend in common on common is exempt,\textsuperscript{73} while dividends in preferred on common,\textsuperscript{74} common on preferred,\textsuperscript{75} or preferred on preferred\textsuperscript{76} are generally\textsuperscript{77} taxable. If only common stock is previously outstanding, a dividend in preferred is not taxable.\textsuperscript{78} The questionable character of the distinction between nontaxable stock dividends and taxable stock dividends has been pointed out elsewhere.\textsuperscript{79} The unwarranted difference in treatment between nontaxable stock dividends and recapitalizations, represented by the

\textsuperscript{73} Compare Helvering v. Griffiths, 318 U.S. 371 (1943) (common on common with only common outstanding); Helvering v. Sprouse, 318 U.S. 604 (1943) (nonvoting common on voting common and nonvoting common with no other outstanding); Eisner v. Macomber, 252 U.S. 189 (1920) (common on common with only common outstanding); Benjamin Josephson, 6 T.C.M. 788 (1947) (same). The statement in the text is subject to the qualification that where the outstanding preferred is participating as to dividends or assets on liquidation, a dividend in common on common would increase the proportionate interests of the common stockholders at the expense of the preferred shareholders, and therefore probably be taxable.


Stock rights are taxed under the same basic principles as stock dividends, the proportionate-interest test applying. Miles v. Safe Deposit & Trust Co., 259 U.S. 247 (1922); Charles M. Cooke, Ltd., 2 T.C. 147 (1943); Int. Rev. Code § 115(f)(i), 26 U.S.C.A. § 115(f)(i) (1945); Treas. Reg. 111, § 29.115–7 (1946). However, the contingent nature of stock rights has resulted in unnecessary complexities. Gibson v. Comm'r, 133 F. 2d 508 (C.C.A. 2d, 1943); Chote v. Comm'r, 129 F. 2d 684 (C.C.A. 2d, 1942); Lowndes, op. cit. supra note 72, at 157–70; cf. Palmer v. Comm'r, 302 U.S. 63 (1937) (rights to purchase shares of another corporation).

\textsuperscript{76} Koshland v. Helvering, 298 U.S. 441 (1936). This case commenced the retreat from Eisner v. Macomber, or, as you will, the clarification of the principles embodied in Eisner v. Macomber. The Macomber case involved dividends in common on common with no other class of stock outstanding, and held that such dividends are not constitutionally taxable as income. The Koshland decision was the first of a series of cases which ended with these results: (1) Stock dividends are not taxable to the extent that they are not income within the Sixteenth Amendment as construed up to the time of the enactment of Section 115(f)(1) of the Revenue Act of 1926. That construction embodies the proportionate-interest test. Helvering v. Griffiths, 318 U.S. 371 (1943); Int. Rev. Code § 115(f)(1), 26 U.S.C.A. § 115(f)(1) (1945); Rottschaefer, Present Taxable Status of Stock Dividends in Federal Law, 28 Minn. L. Rev. 106, 162 (1944). (2) Eisner v. Macomber will probably be overruled on the constitutional issue on the first opportunity. Rottschaefer, supra at 192; Lowndes, op. cit. supra note 72, at 149 (1947). The history of the cases is recounted in Magill, Taxable Income 30–58 (1945).

\textsuperscript{77} Helms Bakeries, 46 B.T.A. 308 (1942).

\textsuperscript{78} There is no change in proportionate interests and consequently no taxable dividend in any of these cases if all classes of stock outstanding are each held in the same proportions by the same people, and the new stock is issued pro rata.


\textsuperscript{79} Lowndes, The Taxation of Stock Dividends and Stock Rights, 96 U. of Pa. L. Rev. 147 (1947). "There is some sense in not taxing any stock dividends as income. There is a lot of sense in taxing all stock dividends as income. There is little save nonsense in taxing some stock dividends and not taxing others." Ibid., at 155.
business-purpose requirement, may be disappearing.\textsuperscript{80} It is not entirely unreasonable to make another comparison, contrasting the tax results in the case of the recipient of a dividend in common on common with those in the case of a stockholder who has reinvested his cash dividend in the same or a similar enterprise. When these transactions have been completed, the two shareholders may be in equivalent positions in all respects but one. They may own similar stock of identical par and book value in practically identical enterprises, and their net withdrawals of cash from their investments may be equal; but the cash dividend recipient will be taxed on his dividend, while the one who receives the stock dividend will not be subject to any tax.\textsuperscript{81}

The proportionate-interest test for stock dividends does not apply to transactions under Section 11\textsuperscript{2}(b)(2), which provides for the nonrecognition of gain in exchanges of common for common and preferred for preferred.\textsuperscript{82} At the same time, the capitalization of surplus will not take such an exchange out of Section 11\textsuperscript{2}(b)(2). Thus if preferred shareholders whose dividends are in arrears are issued a preferred stock dividend in satisfaction of the accumulated arrearages, they will be taxed on the market value of the new stock received under the proportionate-interest test.\textsuperscript{83} If, instead, they exchange each old share for one and a half new preferred shares, they will probably avoid recognition of gain, not to mention a dividend tax.\textsuperscript{84} Indeed, if the transaction meets the business-purpose requirement, they can exchange their rights to unpaid cumulative dividends for common stock in a recapitalization with no probable tax consequences.\textsuperscript{85} But a dividend in common on preferred would be taxable.\textsuperscript{86} A further illustration of the results of the application of differing standards to transactions which may produce the same economic effect is provided by a comparison of Section 11\textsuperscript{2}(b)(2) exchanges and recapitalizations. The former type of exchange does not seem to be subject to the requirement of a business advantage to the corporation.\textsuperscript{87} This furnishes opportunities for maneuvering which may become

\textsuperscript{80} Text at notes 56–58 supra.

\textsuperscript{81} Is the difference in results justified merely because the cash dividend recipient has for an interval separated his money from the hazards of the enterprise?

\textsuperscript{82} Int. Rev. Code § 11\textsuperscript{2}(b)(2), 26 U.S.C.A. § 11\textsuperscript{2}(b)(2) (1945); Treas. Reg. \textsuperscript{83} 111, § 29.11\textsuperscript{2}(b)(2)–1 (1946).

\textsuperscript{83} Helms Bakeries, 46 B.T.A. 308 (1942).

\textsuperscript{84} Skenandoa Rayon Corp. v. Comm'r, 122 F. 2d 268 (C.C.A. 2d, 1941), cert. den. 3\textsuperscript{14} U.S. 696 (1941); cf. Okonite Co., 4 T.C. 618, 630–33 (1945), aff'd 15\textsuperscript{5} F. 2d 248 (C.C.A. 3d, 1946). Thus if preferred shareholders whose dividends are in arrears are issued a preferred stock dividend in satisfaction of the accumulated arrearages, they will be taxed on the market value of the new stock received under the proportionate-interest test.\textsuperscript{85} If, instead, they exchange each old share for one and a half new preferred shares, they will probably avoid recognition of gain, not to mention a dividend tax.\textsuperscript{84} Indeed, if the transaction meets the business-purpose requirement, they can exchange their rights to unpaid cumulative dividends for common stock in a recapitalization with no probable tax consequences.\textsuperscript{85} But a dividend in common on preferred would be taxable.\textsuperscript{86} A further illustration of the results of the application of differing standards to transactions which may produce the same economic effect is provided by a comparison of Section 11\textsuperscript{2}(b)(2) exchanges and recapitalizations. The former type of exchange does not seem to be subject to the requirement of a business advantage to the corporation.\textsuperscript{87} This furnishes opportunities for maneuvering which may become

\textsuperscript{85} Koshland v. Helvering, 298 U.S. 441 (1936).

\textsuperscript{86} No case has been found in which the business-purpose test has been applied to a Section 11\textsuperscript{2}(b)(2) exchange. But cf. Comm'r v. Transport Trading and Terminal Corp., 176 F. 2d 570 (C.C.A. 2d, 1949) (Gregory doctrine applicable to Section 11\textsuperscript{2}).
more important if the expected Treasury campaign against exchanges of common for preferred meets with success.88

Transactions involving two steps in the conversion of accumulated corporate profits into cash in the stockholder's bank account are always subject to being judicially treated as one, with a resultant failure to achieve the intended tax result, if they are clearly interdependent.89 This process will defeat only some of the more patent tax avoidance schemes, however, and the truth remains that widely different tax results accompany undiffering economic consequences in many shareholder realizations of corporate earnings. This is the case in transactions involving two steps, as well as in more direct realizations. Tax avoidance is not only possible, but often not very difficult and usually well worth the cost.90 Inequity is not only widespread, but inherent from the beginning in the taxation of stockholders' receipts. The comparisons made here are by no means exhaustive in their description of inequities and avoidance opportunities.

The sale of stock is perhaps the most important means of transforming an undivided interest in corporate profits into cash without incurring a dividend tax. Recapitalizations have been significant in stockholders' avoidance largely as a means of providing stockholders with saleable securities or with securities which could be sold without loss of control. This may lead to these questions: Even though a particular stockholder does avoid dividend taxation by selling all or part of his stock, will not the buyer necessarily be required to make up the difference in taxes higher than he otherwise would have paid? Is not final and total collection by the government inevitable? If this were true, it could well be objected that the taxpayer receiving the profits should be the one to pay the full tax thereon. However, the questions may be answered directly: "No." The buyer will incur no tax liability in converting into cash the interest in accumulated corporate earnings which he purchased from his predecessor, unless the

88 As to the Treasury policy, see authorities cited notes 63 and 64 supra. One Treasury ruling suggests an inclination to attempt to tax the issuance of sinking fund preferred to common stockholders as a stock dividend or in a recapitalization exchange. Darrell, op. cit. supra note 63, at 963. Unless the proportionate-interest test is to be abrogated and the Strassburger case overruled (note 69 supra), this will require a distinction to be drawn between sinking fund preferred and ordinary preferred. But the effect of that means of attack would be negligible so long as ordinary preferred could be issued without taxation and then exchanged for sinking fund preferred without recognition of gain via Section 112(b)(2). Again, if all means of issuing preferred to common shareholders tax-free were eliminated, Section 112(b)(2) suggests the tax-free transfer of nonvoting common to the voting common holders. If the nonvoting common could be marketed, the original stockholders could still realize corporate earnings as capital gains without loss of control. Other possibilities of the use of the section for avoidance can be imagined; the chief doubt in these matters arises from the paucity of authority construing the section.

89 The process is analyzed in Paul and Zimet, Step Transactions, in Paul, Selected Studies in Federal Taxation, Second Series 200 (1938).

90 Possible costs include legal advice and litigation expenses, minor nontax disadvantages in effecting a transaction in a way involving tax advantages, otherwise unnecessary bookkeeping costs, and the expense of going through a form which would not be required by a more direct accomplishment of the same result.
realization is in the form of a cash (or property) dividend.\textsuperscript{91} The cost of the stock to the buyer becomes its basis.\textsuperscript{92} Tax on the buyer's receipts from his investment will be limited by that basis to the tax on income resulting from corporation profits subsequent to his purchase of the shares, if the receipts are from resale, from complete or partial liquidation, or in the form of "boot" in a recapitalization.\textsuperscript{93} The process need never end, unless the buyer is forced to accept too many cash dividends in lieu of alternative forms of realization.\textsuperscript{94}

Judicial lawmakers have long been engaged in plugging loopholes only to reveal others. Congressional lawmakers have patched the statutes with dozens of provisions only to create different kinds of inequity. Some unfairness is probably unavoidable, but gross inconsistencies should not be necessary.\textsuperscript{95} The corporate earnings situation appears to fall largely into the latter class. Judicial interpretation within the ordinary bounds can have relatively little effect in remedying the incongruities between tax treatments of transactions. Statutory change must be broader than usual if it is to avoid further discrepancies.

Conceivable extensions of the \textit{Bedford} and \textit{Bazley} cases may tend to draw the line between dividends and capital adjustments at the same place in several of the intermediate transactions—that is, between partial liquidations and recapitalizations involving "boot," and between stock dividends and recapitalizations without "boot."\textsuperscript{96} Or, politically improbable legislation could make all distributions of earnings in complete and partial liquidations taxable as dividends. This would leave only the transactions culminating in sales open for shareholder realization of corporate profits as capital gains.\textsuperscript{97} Even this proposal would not alter the original comparison between cash dividends and sales of stock, and the contrasting tax results in those two transactions would take on great significance in the absence of loopholes by way of the intermediate transactions.\textsuperscript{98} Proposals to eliminate the complicating factor of the corporate entity,

\textsuperscript{91} This analysis does not take into account such factors as the varying value of money and the effect of general economic conditions of prosperity or depression because these factors are essentially irrelevant to the inquiry at hand.

\textsuperscript{92} Int. Rev. Code \S 113(a), 26 U.S.C.A. \S 113(a) (1945).

\textsuperscript{93} Int. Rev. Code \S 112(c), 26 U.S.C.A. \S 112(c) (1945).

\textsuperscript{94} This unfortunate circumstance will be most likely to occur in the case of widely held corporations, where the stock purchase price will be least likely to have been determined in anticipation of its possible occurrence.

\textsuperscript{95} "Fortuitous minor inequities cannot wholly be excluded; but there must be no opportunities for deliberate systematic avoidance on a large scale, i.e., for altering substantially one's tax liabilities without change in one's real income circumstances." Simons, Federal Tax Reform, 14 Univ. Chi. L. Rev. 20, 21 (1946).

\textsuperscript{96} Authorities cited notes 45, 58 and 69 supra.

\textsuperscript{97} Cash payments to shareholders in recapitalizations, the other transaction not covered by the suggested legislation, are now largely closed to stockholder realization of corporate earnings without dividend taxation. Comm'r v. Estate of Bedford, 325 U.S. 283 (1945); note 40 supra.

\textsuperscript{98} Speculation on the effect of such legislation may bring to mind various evils resulting from the unnatural influences of a tax system which places such a premium on sales of stock alone, while it relatively burdens liquidations.
by taxing corporate owners as though they were partners, are fraught with tremendous administrative difficulties. Moreover, these proposals would retain the unfairness of arbitrary fiscal year allocation of income without ultimate and certain reconciliation of the individual stockholder’s tax “realizations” with his aggregate economic gain or loss on his investment. The only complete solution seems to be the removal of the sources of the inconsistencies, which are the discrimination between capital gains and ordinary income, the “unrealized” gain loophole at death, and the stress on timing created by the fiscal year allocations of the present system. These changes would of course go far toward revamping the entire income tax, and they have been ably advocated as part of such general proposals. Reform of this scope is, however, improbable in the near future.

PATENT POOLING AND THE ANTI-TRUST LAWS

In that broad field where the policies behind the anti-trust laws and the patent laws clash for supremacy the Supreme Court has for many years moved to extend the scope of the Sherman Act at the expense of claimed rights of the patentee. With the decisions in the Gypsum and Line Material cases early in 1948 this movement reached its farthermost limits to date. But if these decisions served to tell the patentee what he may not do with his patent, they by no means left clear the area in which a legal monopoly may be validly exploited. The first important district court decision to be rendered since those cases throws a good deal of light on the manner in which the federal courts may be expected to comply with the pronouncements of the high tribunal, and in addition opens up some relatively unexplored corners of the anti-trust domain.

United States v. Carboloy provides an opportunity to study the manner in which two patentees, one American and one German, by combining their efforts, were able to achieve virtually complete domination of a new-born industry and

102 Simons, op. cit. supra note 95, at 21-23.