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Corporate Distributions and the Income Tax: A Consideration of the Inconsistency Between Subchapter C and Its Underlying Policy

Charles O'Kelley

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Corporate Distributions and the Income Tax: A Consideration of the Inconsistency Between Subchapter C and Its Underlying Policy

*Charles R. O'Kelley, Jr.**

I. INTRODUCTION

A shareholder may realize the gain on his investment by selling his shares to a new investor, by "selling" his shares to the issuer, or by receiving a distribution of corporate assets as a dividend. A sale of shares results in income to the seller, but only to the extent that the amount realized exceeds the seller's adjusted basis. In contrast, a pro rata distribution "out of its earnings and profits" by an ongoing corporation in the ordinary course of business is a dividend and must be included in a shareholder's gross income without allowance for recovery of the cost of the shares.[1] Additionally, while the gain on a sale of shares is capital gain, a dividend is ordinary income.

The issue of whether the sale of shares to an issuer shall be treated as a dividend or as received in exchange for a capital asset has troubled Congress, courts, and commentators since the Revenue Act of 1913. If a corporation redeems some of its shares or

* Associate Professor of Law, University of Alabama. B.A., University of the South, 1970; J.D., University of Texas at Austin, 1972; LL.M, Harvard University, 1977. Research for this Article was supported by the University of Alabama Research Committee Grant Number 1070.

1. I.R.C. §§ 301, 316(a). In this Article all distributions are out of, or covered by, earnings and profits except when otherwise stated.

distributes all of its assets in complete liquidation, the transaction is generally described as having the characteristics of a dividend to the extent the distribution is "out of earnings and profits" and the characteristics of a sale to the extent that it terminates the equity interest of the redeemed party.[2] In light of the existence of equally compelling analogies, each suggesting the opposite treatment, it has been suggested that in determining the appropriate treatment of distributions in complete liquidation or redemption, analogizing the transaction to a sale or a dividend is of limited value.[3]

A critical error permeates this analysis. The assumption is made that to the extent that a corporate distribution is "out of earnings and profits," the distribution is analogous to a dividend. This assumption leads proponents of reform to suggest dividend treatment, or its equivalent, for distributions in redemption of some or all of a corporation's shares.[4] Meaningful suggestions for reform must, however, begin with an understanding of when a distribution is, or is not, analogous to a dividend under the present system—that is, with an understanding of how one must define a dividend to comport with the fundaments of the present system.[5]

This Article suggests that although one part of a corporate distribution may be analogous to a sale and the remainder to a dividend, there is no overlap of, or competition between, analogies. This lack of overlap is apparent when one realizes that a dividend and a sale are methods of realizing different types of gain, rather than alternative methods of realizing the same type of gain. This Article examines the basic conceptual model underlying the present system of taxing corporate distributions, describes the appropriate treatment of corporate distributions that is suggested by an understanding of the underlying concepts, and indicates the dis-

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2. Bittker, *Stock Redemptions and Partial Liquidations Under the Internal Revenue Code of 1954*, 9 STAN. L. REV. 13, 14 (1956); Bittker & Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX. L. REV. 437, 448-50 (1950); Chirelstein, *Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares*, 78 YALE L.J. 739, 749 (1969); Cohen, Surrey, Tarleau & Warren, *A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders*, 52 COLUM. L. REV. 1, 23-24 (1952) [hereinafter cited as Cohen *et al.*]; Magill, *The Income Tax Liability of Dividends in Liquidations*, 23 MICH. L. REV. 565, 566-68 (1925).

3. ALI FEDERAL INCOME TAX PROJECT: SUBCHAPTER C CORPORATE DISTRIBUTIONS 94 (Tent. Draft No. 2 1979) [hereinafter cited as ALI TAX PROJECT].

4. *See, e.g., id.* at 100-58; Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743, 764-66, 772 (1979).

5. For a discussion of the importance of understanding the basic underlying principles of corporate taxation, see Clark, *The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform*, 87 YALE L.J. 90, 93 (1977).

crepancies between the present Code and this model.

While the rules governing corporate distributions may be stated in the abstract, they have no life or meaning except in relation to real corporations and their investors. Therefore, to illustrate the points discussed herein reference will be made periodically to transactions involving the following described hypothetical: *X* Corporation was organized in Year One. On January 1 of each year since Year Nine it has had a net book value of $10,000,000, which consisted of $1,000,000 in contributed capital and $9,000,000 in retained earnings and profits. Since Year Ten the reasonable, present business needs of *X* Corporation have required the retention of $9,000,000 of earnings and profits, but no more. Each year since Year Ten *X* Corporation has had earnings and profits of $1,000,000 and has at year end distributed pro rata to its shareholders this amount of money. Since Year Ten the market has valued *X* Corporation shares at approximately ten times earnings, or $10 per share. *X* Corporation has 1,000,000 outstanding shares. Individual *A* has owned 10,000 of the shares of *X* corporation since its formation. *A*'s basis for his shares is $10,000. Individual *B* has owned 10,000 of the shares of *X* Corporation since Year Ten. *B*'s basis for his shares is $100,000.

II. Dividends and Sales

On December 31, Year Eleven, *X* Corporation distributes $1,000,000 pro rata to its shareholders as a dividend. On January 1, Year Twelve, *A* and *B* each receive $100,000 in exchange for their shares. If *A* and *B* receive such amounts through sale of their shares to new investors, the transaction has always been treated as an exchange with the result that *A* has income to the extent of his $90,000 gain, and *B* has no gain and no income. The question raised here is whether the result should be different if such amounts are received from the corporation in redemption of their shares.

The early revenue acts provide an appropriate starting point to address this issue. Prior to the Revenue Act of 1918 no statute expressly dealt with distributions in redemption. Both the Revenue Act of 1913 and the Revenue Act of 1916 included "dividends" as an item of income.[6] A distribution out of earnings and profits

6. Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 757; Revenue Act of 1913, ch. 16, § II B, 38 Stat. 167.

was a dividend.[7] A sale of shares was an exchange transaction resulting in income only to the extent of gain. To determine whether a distribution in partial or complete liquidation would be characterized as a dividend or an exchange transaction under the Revenue Acts of 1913 and 1916 requires an understanding of the relationship between, and the nature of, a dividend and a sale of shares. To reach this understanding, one must consider a number of questions. For example, what is a dividend? Why is exchange treatment afforded to sales? To what extent can the proceeds of a sale of shares be considered a realization of undistributed earnings and profits? Should any portion of the proceeds of a sale of shares be treated as a dividend?

Consider first the sale by *A*. On January 1, Year Twelve, *A*'s share of *X* Corporation's contributed capital is $10,000, and his share of undistributed earnings and profits is $90,000. The market value of his shares is $100,000. Therefore, *A* has an unrealized gain attributable to his share of undistributed earnings and profits that may be realized by sale of his shares.[8] Indeed, since *X* Corporation must retain all of its earnings and profits to meet the needs of its business,[9] *A*'s unrealized gain can be realized only by selling his shares. Can *A* be treated as having received his gain out of earnings and profits when *X* Corporation has no distributable assets?

A source of distributable funds is provided by the purchaser. We can view the new investor as contributing the $100,000

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7. The Revenue Act of 1913 contained no definition of "dividends." The Revenue Act of 1916 defined "dividends" as "any distribution . . . out of its earnings or profits accrued since March first, nineteen hundred and thirteen." Revenue Act of 1916, ch. 463, § 2(a), 39 Stat. 757. In Lynch v. Hornby, 247 U.S. 339 (1918), the Supreme Court defined "dividends," as used in the Revenue Act of 1913, to include ordinary distributions out of earnings and profits whenever earned. *Id.* at 344.

8. A simple model is being used for our initial inquiry. *See* Part 1 *supra*. The model assumes that the book value of the corporation's assets remains constant and is identical to the fair market value of these assets. Moreover, it assumes that the value of the enterprise as a going concern is equal to the value, in the aggregate, of those assets that constitute the business of the corporation (operating assets, including needed working capital). Accordingly, the total value of the corporation should it be liquidated is equal to the sum of its undistributed earnings and profits and its contributed capital. In real life the intersection of enterprise value, asset value, and the historic value of the corporation's contributed capital and undistributed earnings and profits would be rare. The consequence of this lack of intersection and of the significance of the earnings and profits concept is discussed at note 87 *infra*. For now it is enough to note that this simple model allows us to speak of a distribution "out of earnings and profits" with the comfortable understanding that the reference is to a distribution of assets constituting the tangible resting place of the same amount of the corporation's previously undistributed net profit.

9. Generally, this Article uses the term "needed earnings and profits" to describe that portion of earnings and profits that must be retained to meet the needs of the business.

purchase price to *X* Corporation, which simultaneously redeems *A*'s shares and reissues them to the new investor. So viewed, the transaction can be characterized as a distribution to *A* by the corporation of his pro rata share of earnings and profits ($90,000) and a return of his pro rata share of contributed capital ($10,000).

The sale by *B* presents a different situation. *B* is in the same position as the new investor who purchased *A*'s shares. We must treat *B* as originally having contributed $100,000 (his basis) to *X* Corporation to enable it to redeem a prior investor. Thus, even if the amount realized by *B* is treated as passed through *X* Corporation, this sum does not represent a distribution out of earnings and profits, but rather a return of his previously invested capital.

This analysis confirms the conclusion that exchange treatment is the appropriate way to determine the amount of income resulting from a sale of shares. It shows that, to the extent of the seller's pro rata share of earnings and profits, the gain on a sale of shares (as opposed to the total amount realized) can be considered to be "out of earnings and profits." The question remains, however, whether the gain on a sale of shares should be characterized as a dividend to the extent it is deemed to be out of earnings and profits.

The next step, then, must be to determine when a distribution out of earnings and profits is a dividend. In the absence of a statutory answer, the Supreme Court interpreted the term "dividends" in the Revenue Act of 1913 to mean "the tangible and recurrent returns upon . . . stock, analogous to the interest and rent received upon other forms of invested capital."[10] A dividend, the Court noted, "demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares."[11] Interpreting the statutory definition of dividends in the Revenue Act of 1918,[12] the Court described a dividend as "the recurrent return upon stock paid to stockholders by a going corporation in the ordinary course of business, which does not reduce their stockholdings and leaves them in a position to enjoy future returns upon the same stock."[13]

Could a distribution out of earnings and profits needed by the business be a dividend within the Supreme Court's definition? If a

10. Lynch v. Hornby, 247 U.S. 339, 344-45 (1918).
11. *Id.* at 346.
12. Revenue Act of 1918, ch. 18, § 201(c), 40 Stat. 1059 (1919).
13. Hellmich v. Hellman, 276 U.S. 233, 237 (1928).

corporation distributes assets needed by the business, the business will suffer and earning capacity will be reduced. Rather than demonstrating that future dividends can be expected, the distribution would impair capital and reduce share value. By contrast consider the yearly distribution by *X* Corporation of the $1,000,000 that is attributable to surplus earnings and profits of the year. These distributions are in the nature of a recurrent return on capital, rather than a return of capital. They do demonstrate the earning capacity of the corporation and leave the shareholder in a position to expect future dividends.

This suggests that corporate earnings and profits may be divided conceptually into two distinct elements—surplus earnings and profits and needed earnings and profits.[14] Surplus earnings and profits—those in excess of the needs of the business—can be distributed, and these distributions should be dividends. Indeed, Congress has always sought to compel the distribution of surplus earnings and profits.[15] Needed earnings and profits, however, are entirely different. In the ordinary course of business, the gain represented by needed earnings and profits can only be realized by a sale of shares, and this gain cannot fairly be characterized as a dividend. Therefore, only surplus earnings and profits, not the total undistributed earnings and profits, constitute a reservoir from which the government expects future dividends.[16]

It is necessary to analyze one final situation before moving to a consideration of nondividend distributions—a sale of shares at a time when the corporation has surplus earnings and profits. For instance, suppose that on December 31, Year Eleven, immediately before the declaration of the annual dividend, *B* sells his shares.[17]

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14. Thus, in our simple model, the needed earnings and profits of *X* Corporation are $9,000,000. Its annual earnings of $1,000,000, which are not needed in the business, are surplus earnings and profits.

15. The Revenue Act of 1913 contained the predecessor of our present accumulated earnings tax. Included in the taxable income of an individual was his share of corporate earnings and profits "that are permitted to accumulate beyond the reasonable needs of the business." Revenue Act of 1913, ch. 16, § II A(2), 38 Stat. 166. The accumulated earnings tax now imposes a penalty tax on corporations that accumulate earnings and profits for the purpose of avoiding the income tax with respect to its shareholders that would result from distribution. I.R.C. § 532(a). Improper purpose is indicated when accumulations are shown to be "beyond the reasonable needs of the business." I.R.C. § 533(a).

16. Many commentators err in viewing the entire undistributed earnings and profits account as a reservoir from which future dividends can be expected. *See generally* ALI TAX PROJECT, *supra* note 3, at 100-58; Beghe, *supra* note 4, at 764-66, 772.

17. Assume for our purposes that the dividend is paid to the person owning a share at the moment in time when a dividend is declared.

At the time of sale, *B*'s pro rata share of surplus earnings and profits is $10,000. If *B* receives $110,000 for his shares, it might seem appropriate to characterize $10,000 of the proceeds as a dividend, and the remainder as a return of capital.

There are problems with this characterization, however. It is unlikely that a purchaser would be willing to "loan" *B* $10,000 interest free for the period of time between the purchase date and the date of delivery of the dividend. It is also likely that a purchaser would require some compensation for the risk that the dividend would not be declared. Clearly a purchaser would require a discount for interest and risk.

Different problems would arise if *B* were to sell his shares for only $108. For example, would *B* have a $10 dividend and a $2 loss on the sale of his shares, or an $8 dividend, or an $8 gain? The problem involved is central to the entire concept of capital gains—how to separate recurrent profits from the gain on the disposition of capital.[18]

The difficulty increases when one considers sales of shares during the year. Must a portion of the gain on each transaction be characterized as a dividend to the extent of the seller's allocable share of any dividend actually issued? What if the price fluctuates widely during the year in a manner that does not fairly reflect the accumulation of a distributable surplus?[19] These complexities serve to reinforce the central point—unlike needed earnings and profits, surplus earnings and profits can be distributed. A shareholder expects them to be distributed, and Congress has always done its best to require that they be distributed.[20] Should we not then await the actual distribution of surplus earnings and profits and treat this distribution as a dividend in full to the actual recipient?

The Supreme Court sanctioned this result in *United States v. Phellis.*[21] The Court described the position of *B*'s purchaser who receives a dividend shortly after the purchase from *B:*

> In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped

18. *See* M. DAVID, ALTERNATIVE APPROACHES TO CAPITAL GAINS TAXATION 25-28 (1968); Surrey, *Definitional Problems in Capital Gains Taxation,* 69 HARV. L. REV. 985 (1956).

19. *See* Cohen *et al., supra* note 2, at 23.

20. *See* note 15 *supra.*

21. 257 U.S. 156 (1921).

into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.[22]

A sale of shares, then, is the vehicle by which a shareholder realizes gain attributable to needed earnings and profits and assigns the right to receive future dividends. A dividend is a distribution made in the ordinary course of business out of surplus earnings and profits, which leaves the value of the underlying enterprise unaffected.

III. Distributions in Complete Liquidation

A. *The Proper Analogy to Sales*

If a sale is properly entitled to exchange treatment and represents the method of realizing needed earnings and profits, and if a dividend is a distribution of surplus earnings and profits in the ordinary course of business by an ongoing corporation, how should one characterize a distribution in complete liquidation? Consider the complete liquidation of *X* Corporation on January 1, Year Twelve. Having declared no dividend at year end, *X* Corporation distributes $110,000 to *A* and $110,000 to *B*.

These distributions are literally out of earnings and profits to the extent of $100,000. *B* purchased his shares, however, for $100,000, which capitalized the portion of the liquidating distribution attributable to needed earnings and profits.[23] While *A* did not sell his shares prior to receiving the distribution in liquidation, he could have realized the gain attributable to needed earnings and profits by sale. Therefore, equity, and the analogy to sales treatment, requires that *A* be allowed to treat $100,000 of the liquidating distribution as received in exchange for his shares.

The analogy to sales treatment breaks down when applied to the portion of the liquidating distribution attributable to surplus earnings and profits. Both *A* and *B* have received $10,000, which is attributable to surplus earnings and profits. An investor purchases shares with the understanding that the corporation will distribute surplus earnings and profits periodically and that the distribution will be treated as a dividend in full.[24] Unlike a sale, the corporation

22. *Id.* at 171-72.
23. *See* text accompanying notes 8-19 *supra.*
24. *See* text accompanying note 21 *supra.*

makes an actual distribution of surplus earnings and profits. Unlike a sale, no new investor exists who will ultimately receive the surplus earnings and profits as a dividend. Unlike a sale, no problem of multitudinous transactions and imprecise market valuation occurs.[25] Therefore, the portion of a liquidating distribution attributable to surplus earnings and profits should be treated as a dividend.

Determining the appropriate treatment of liquidating distributions by analogy has been criticized because the liquidating distribution, in its entirety, seems analogous to both a sale and a dividend.[26] When one recognizes the bifurcated nature of earnings and profits, it is clear that a liquidating distribution can be in part a dividend and in part a sale.[27] The problem, then, lies in trying to characterize the entire distribution as either a dividend or a sale. The history of congressional attempts to place liquidating distributions properly within the basic framework demonstrates that the bifurcated nature of earnings and profits has not been perceived.

B. The Historical Treatment

The Revenue Acts of 1913 and 1916 contained no provision explicitly governing liquidating distributions. The Acts defined dividends as distributions out of earnings and profits.[28] Although a liquidating distribution would literally be out of earnings and profits and would thus be a dividend, the foregoing analysis indicates that a literal reading would be incorrect.[29]

The Bureau of Internal Revenue interpreted a liquidating distribution as analogous to a sale rather than a dividend under the 1913 and 1916 Acts, because it constituted a distribution of "not only the surplus earnings of the M Company, but all of its capital, which could not be done by an ordinary dividend."[30] Thus, the amount of income was the gain, the excess of amount realized over basis.[31]

After the Bureau had issued its interpretation, however, three

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25. *See* note 19 *supra* and accompanying text.

26. ALI TAX PROJECT, *supra* note 3, at 94; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.01 (4th ed. 1979).

27. If *X* Corporation distributes its annual dividend, leaving it with no surplus earnings and profits, and then liquidates, the liquidating distribution is, of course, completely analogous to a sale.

28. *See* notes 6-7 *supra* and accompanying text.

29. *See* Part III, Section A *supra*.

30. T.B.R. 45, 1 C.B. 19 (1919).

31. S. 971, 1 C.B. 79 (1919).

courts rendered decisions against the Bureau. Because of these decisions one commentator characterized a liquidating distribution as a dividend under the 1913 and 1916 Acts to the extent that it was out of earnings and profits.[32] All three cases[33] involved original shareholders like *A*. The portion of the distribution attributable to earnings and profits was, therefore, not in excess of the shareholder's gain. The cases are not inconsistent with the Bureau's position, or the above analysis: gain is still the amount of income resulting from a liquidating distribution. The question involved in these cases was "simply" whether that gain should be characterized as a dividend.

As the amount of income was not at issue in these cases, one might question the taxpayer's insistence on characterizing the gain as a dividend rather than as the product of a sale. The answer, often overlooked in light of the present treatment of dividends,[34] is the preferential tax treatment dependent on dividend characterization. In the Revenue Acts of 1913, 1916, and 1918, it was preferable, from the taxpayer's viewpoint, to characterize the income as a dividend. The Acts exempted dividends from the normal tax,[35] while imposing both the normal tax and a surtax on gains from sales.[36]

The Revenue Act of 1918 expressly adopted the Bureau's position that liquidating distributions should be treated as sales.[37] The Revenue Act of 1921, however, included neither a provision explicitly covering liquidating distributions nor an explanation for this omission. In the absence of an expression of congressional intent to the contrary, it might be expected that the Bureau would have continued under the Revenue Act of 1921 to treat liquidating dis-

32. Darrell, *Corporate Liquidations and the Federal Income Tax*, 89 U. PA. L. REV. 907, 908 (1941). *See also* Bittker & Redlich, *supra* note 2, at 450; Bruce, *Liquidations and Reorganizations:* Madison Square Garden *and* Kass, 30 TAX L. REV. 303, 306-07 (1975).

33. Vincent v. McLaughlin, 61 F.2d 657 (9th Cir. 1932); A.B. Nickey & Sons, 3 B.T.A. 173 (1925); James Dobson, 1 B.T.A. 1082 (1925).

34. This historical quirk is generally overlooked. The consequence is an analysis of the evolution of our present system based on the incorrect assumption that dividend characterization has always been an anathema to individual taxpayers and sought after by the Service. *See* Bruce, *supra* note 32, at 306-07, 310-11; Clark, *supra* note 5, at 100, 106.

35. Revenue Act of 1918, ch. 18, § 216(a), 40 Stat. 1069 (1919); Revenue Act of 1916, ch. 463, § 5(b), 39 Stat. 759; Revenue Act of 1913, ch. 16, § II B, 38 Stat. 167.

36. Revenue Act of 1918, ch. 18, § 211(a), 40 Stat. 1062 (1919); Revenue Act of 1916, ch. 463, § 1(b), 39 Stat. 756; Revenue Act of 1913, ch. 16, § A(2), 38 Stat. 166.

37. The Revenue Act of 1918 provided that "[a]mounts distributed in the liquidation of a corporation shall be treated as payments in exchange for stock or shares, and any gain or profit realized thereby shall be taxed to the distributee as other gain or profits" rather than as dividends. Revenue Act of 1918, ch. 18, § 201(c), 40 Stat. 1059 (1919).

tributions as sales of shares, just as they had done under the Revenue Acts of 1913 and 1916, which also contained no provision explicitly governing distributions in complete liquidation. As under the earlier Acts, the Bureau treated only the gain on liquidating distributions as income. The Bureau, however, took the position that this gain was to be characterized as a dividend exempt from the normal tax, rather than as gain from the sale of shares subject to both the normal tax and surtax.[38]

Thus, the Bureau interpreted the Revenue Act of 1921 differently from the Revenue Act of 1916, although neither of the Acts expressly exclude liquidating distributions from the dividend definition, and both of the Acts are devoid of legislative history indicating congressional intent. Perhaps it is not too cynical to suggest that the Bureau, charged with the responsibility to collect the revenue, would naturally interpret ambiguous language in a manner designed to produce the greatest revenue.[39] It is important to remember that the Revenue Act of 1921 contained the first capital gains preference.[40] The ball game had changed; the recipient of a liquidating distribution would now, in most cases, receive the most preferable tax treatment by characterizing his gain as gain from the sale of shares, rather than as a dividend.[41]

It is understandable that taxpayers prior to 1921 would attempt to treat gains from liquidating distributions as dividends, and after 1921[42] as the proceeds of a sale of stock. It is perhaps also understandable, although regrettable, that the Bureau would

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38. Regulations promulgated under the Revenue Act of 1921 defined distributions in liquidation as follows:

> Where a corporation distributes all of its property in complete liquidation or dissolution, the gain realized by the stockholder from the transaction, computed under section 202, is taxable as a dividend to the extent that it is paid out of earnings or profits of the corporation accumulated since February 28, 1913. If the amount received by the stockholder in liquidation is less than the cost or other basis of the stock, a deductible loss is sustained.

Regulation 62, T.D. 3295 (1922) (construing Revenue Act of 1921, ch. 136, § 201, art. 1545, 42 Stat. 228).

39. For a good discussion of the role that the natural tendencies of taxpayers and the Service play in the development of corporate taxation, see Clark, *supra* note 5, at 94-96.

40. The Revenue Act of 1924 provided an optional tax of 12½% on "capital net gain" in lieu of the normal tax and surtax otherwise payable. Revenue Act of 1924, ch. 234, § 208(b), 43 Stet. 263.

41. For net incomes in excess of $8,000 the normal tax was 6%, and for net incomes in excess of $500,000 the surtax was 40%. Lesser rates were applicable to net incomes below these amounts. Revenue Act of 1924, ch. 234, §§ 210, 211(a), 43 Stat. 264.

42. The exemption of dividend income from the normal tax, which was of little consequence after 1921, ended in 1936.

take the contrary position. If the Bureau had had the foresight and wisdom to characterize liquidating distributions under either the 1921 Act or the earlier Acts as analogous in some respects to sales, but in other respects to dividends, much of the later difficulty in the characterization and treatment of partial liquidations and corporate separations might have been avoided. Of course, to be fair, the Bureau may not have realized the nature of the problem. To analyze the issue properly, two distinct questions must be answered. First, should capital gain be taxed preferentially?[43] Second, what portion of a liquidating distribution, if any, is capital gain? It is apparent that these questions are often not separated.[44]

In any event, the Bureau failed to comprehend the complexity of the issue before it. The Bureau's interpretation was inequitable to a shareholder in *A*'s position. It would require *A* to treat $100,000 of the liquidating distribution as a dividend, but would require *B* to treat only $10,000 as such. If *A* had sold prior to the distribution, however, he could have treated his gain as capital gain. Moreover, *B* could avoid dividend treatment entirely by selling his shares for $110,000 immediately before the liquidation. In 1924 Congress reacted to the Bureau's interpretation by again expressly providing for the treatment of distributions in complete liquidation, in their entirety, as sales of shares.[45]

Since 1924, except for a brief hiatus between 1934 and 1936,[46] Congress has always treated distributions in complete liquidation as sales of shares. Never has Congress treated the gain on distributions in complete liquidation as a dividend, in part or in full.[47] This failure to provide dividend treatment to the portion of a liquidating distribution that is out of surplus earnings and profits has infected the entire statutory structure governing corporate distributions.

43. The propriety of a capital gains preference is beyond the scope of this Article. For a good discussion of this issue, see M. DAVID, *supra* note 18, at 37-38; 73 YALE L.J. 693, 695-701 (1964).

44. *See, e.g.*, Chommie, *Section 346(a)(2): The Contraction Theory*, 11 TAX L. REV. 407, 407 (1956).

45. Revenue Act of 1924, ch. 234, § 201(c), 43 Stat. 255.

46. The Revenue Act of 1934 treated distributions in complete liquidation as short term capital gain. Revenue Act of 1934, ch. 277, § 115(c), 48 Stat. 711. The Revenue Act of 1936 again made distributions in complete liquidation eligible for sales treatment in full. Revenue Act of 1936, ch. 690, § 115(c), 49 Stat. 1687.

47. The current code provides that "[a]mounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." I.R.C. § 331(a).

IV. Partial Liquidations and Redemptions

A. Background

Consider the situation of a corporation that makes a distribution out of earnings and profits in exchange for some of its outstanding shares but not in complete liquidation. Such a "partial" liquidation was literally a dividend under the Revenue Acts of 1913, 1916, and 1921 to the extent that it was made out of earnings and profits.[48] The Revenue Act of 1918 expressly accorded exchange treatment to liquidating distributions,[49] and the Bureau interpreted this as applying to a partial liquidation.[50] The Bureau again treated partial liquidations like complete liquidations under the Revenue Act of 1921.[51] The Acts provided no guidelines for determining when a transaction should be characterized as a partial liquidation. In keeping with the favorable revenue consequences, the Bureau may well have characterized any transaction involving a redemption of shares as a partial liquidation.[52]

Partial liquidations first received express statutory status in the Revenue Act of 1924. The Act treated distributions in partial liquidation like sales of shares[53] and defined partial liquidations as distributions "in complete cancellation or redemption of a part of its stock."[54] Concerned that taxpayers were disguising dividends as partial liquidations to obtain both exchange and capital gains treatment, Congress, in the Revenue Act of 1926, provided dividend treatment to distributions in redemption that were "essentially equivalent to a dividend."[55] In 1934 Congress relegated to short-term capital gain status the gain on partial and complete liquidations.[56] Although Congress restored gains on complete liquidation to the status of other sales of shares in 1936,[57] gains on partial liquidation were not again accorded long-term capital gains treatment until 1942.[58]

Prior to 1954, as the courts struggled with the definition of

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48. *See* notes 6-7 *supra;* Revenue Act of 1921, ch. 136, § 201(a), 42 Stat. 228; Murphy, *Partial Liquidations and the New Look,* 5 Tax L. Rev. 73, 74 (1949).

49. Revenue Act of 1918, ch. 18, § 201(c), 40 Stat. 1059 (1919).

50. O.D. 488, 2 C.B. 29 (1920).

51. I.T. 1543, II-1 C.B. 17 (1923).

52. *See* notes 37-38 *supra* and accompanying text.

53. Revenue Act of 1924, ch. 234, § 201(c), 43 Stat. 255.

54. *Id.* at § 201(g), 43 Stat. 255.

55. Revenue Act of 1926, ch. 27, § 201(g), 44 Stat. 11.

56. Revenue Act of 1934, ch. 277, § 115(c), 48 Stat. 711.

57. Revenue Act of 1936, ch. 690, § 115(c), 49 Stat. 1687.

58. Revenue Act of 1942, ch. 619, § 147, 56 Stat. 841.

partial liquidation,[59] two criteria seemed to emerge. If a "genuine contraction of the business" occurred, then even a pro rata distribution in redemption was a partial liquidation.[60] If a distribution was sufficiently non pro rata, then it constituted a partial liquidation.[61] A third, generally discredited, approach treated a redemption like a sale if no cancellation of shares occurred.[62]

The Revenue Act of 1954 brought some order to the area. Sections 331 and 346 govern partial liquidations involving the contraction concept. Section 302 governs those distributions in redemption involving the non pro rata concept. Under the 1954 Act a distribution in partial liquidation is entitled to exchange treatment.[63] The Act defines a distribution in redemption as a partial liquidation if it "is not essentially equivalent to a dividend."[64] The legislative history indicates that the appropriate inquiry is whether the distribution is in connection with "a genuine contraction of the business."[65] Section 346(b) provides a safe harbor for any distribution in redemption that is attributable to the cessation of one of two trades or businesses, each of which has been actively conducted by the corporation for the prior five years.[66] A distribution in redemption, whether or not in connection with a genuine contraction of a business, is entitled to exchange treatment under section 302[67] if the transaction is sufficiently non pro rata.[68] Safe harbors are provided for redemptions that completely terminate or substantially reduce a shareholder's interest in the corporation.[69]

While sections 346 and 302 provide more certainty for tax planning and more guidance in determining when exchange treatment will be extended, no clear rationale for the distinctions is articulated. What is the underlying rationale of these sections? Are sections 346 and 302 consistent with the underlying rationale? If

59. *See* Bittker & Redlich, *supra* note 2, at 455-80; Chommie, *supra* note 44.

60. Bittker & Redlich, *supra* note 2, at 471-73; Chommie, *supra* note 44, at 417-22.

61. Bittker & Redlich, *supra* note 2, at 469.

62. *Id.* at 458-65.

63. I.R.C. § 331(a)(2).

64. I.R.C. § 346(a)(2).

65. *See* S. Rep. No. 1622, 83d Cong., 2d Sess. 262 (1954).

66. I.R.C. § 346(b).

67. The Internal Revenue Code states that "[i]f a corporation redeems its stock . . . and if paragraph (1), (2), (3) or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock." I.R.C. § 302(a).

68. The Internal Revenue Code states, "Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend." I.R.C. § 302(b). This hurdle cannot be cleared if the distribution is pro rata. United States v. Davis, 397 U.S. 301 (1970).

69. I.R.C. §§ 302(b)(2)-(5), 302(c).

not, what is the proper treatment? To answer these questions one must build on the foundation provided by a proper understanding of the nature of a dividend and of the difference between gain attributable to surplus earnings and profits and gain attributable to needed earnings and profits.[70]

B. Partial Liquidations and Section 346

The analogy between distributions in partial liquidation and distributions in complete liquidation provides the basis for extending exchange treatment to distributions in partial liquidation. The argument is made that exchange treatment must be allowed when a corporation terminates one of two businesses, each carried on since the formation of the corporation. The basis for this argument is that the terminated business could have been separately incorporated and the complete liquidation of the separate corporation would have been treated as an exchange transaction.[71] When one accepts this premise that some distributions in partial liquidation are entitled to exchange treatment, the question becomes one of deciding which distributions are in partial liquidation.

There has been considerable reluctance, however, to accept the premise that any partial liquidation is entitled to exchange treatment. On one level the refusal is based on the belief that any pro rata distribution out of earnings and profits is a dividend;[72] the proper inquiry, however, is whether the distribution is out of *surplus* earnings and profits.[73] On a second level, the original incorporation analogy is challenged both as an attempt to rewrite history and as unpersuasive when applied to a contraction of a single business.[74]

An evaluation of the proper treatment of distributions attributable to the termination of one of two businesses necessarily requires one to consider the situation if the business had been separately incorporated. The mere fact that the businesses could have been separately incorporated, however, is of no importance. To il-

70. *See* note 16 *supra* and accompanying text; Part III, Section A *supra.*

71. *See* Nolan, *The Uncertain Tax Treatment of Stock Redemptions: A Legislative Proposal,* 65 HARV. L. REV. 255, 264-65 (1951).

72. *See, e.g.,* Bittker & Redlich, *supra* note 2, at 476. "Dividends are distributions of earnings and profits to the stockholders which do not change their proportionate interests in the corporation. Any distribution in cancellation or redemption of some of the corporation's stock which meets this test should be [treated as a dividend]." (footnote omitted). *Id.*

73. *See* discussion in Part I *supra.*

74. Cohen *et al., supra* note 2, at 38.

lustrate let us consider two hypothetical distributions made by *X* Corporation.[75]

Situation No. 1: *X* Corporation from the outset has carried on two separate and distinct businesses, one the manufacture and sale of brushes, the other the manufacture and sale of soap. Each business uses one-half of the original capital and one-half of the needed earnings and profits. Thus, the market values each business at $5,000,000, of which $500,000 is attributable to original capital and $4,500,000 to needed earnings and profits. Each business generates $500,000 in surplus earnings and profits each year. Each business generates all of the needed earnings and profits of that business.

Situation No. 2: *X* Corporation from the outset has carried on two separate and distinct businesses, one the manufacture and sale of brushes, the other the owning and operating of a resort hotel. The corporation invested its original capital in the brush business and purchased the hotel for $5,000,000, with the purchase price totally deferred and payable in ten equal annual installments of principal. The hotel note required interest to be paid in equal annual installments over the ten-year life of the note. The brush business annually generated $1,000,000 in earnings and profits. The hotel business annually generated sufficient gross income to exactly cover its operating expenses and the interest due on the hotel note. Thus, the hotel business had no annual earnings and profits. The corporation used $500,000 of the earnings and profits of the brush business each year to make the principal payment due on the hotel note. Through Year Eight the brush business needed and thus retained the remaining earnings and profits.

At the beginning of Year Eleven, *X* Corporation distributes pro rata to its shareholders $5,000,000. In Situation No. 1 the distribution represents the proceeds of the sale of the soap business. In Situation No. 2 the distribution represents the proceeds of the sale of the hotel. Should these distributions be entitled to exchange treatment? Are they analogous to distributions in complete liquidation?

In Situation No. 1 the two businesses could have been placed in separate corporations at the outset. At the beginning of Year Eleven, the separate corporation housing the soap business could distribute $5,000,000 to its shareholders in complete liquidation. This distribution would have been attributable entirely to original

75. *See* description in Part I *supra.*

capital and needed earnings and profits, and the recipients would be entitled to exchange treatment.[76] Thus, the identical distribution in partial liquidation should be entitled to exchange treatment.

In Situation No. 2 the two businesses could also have been placed in separate corporations at the outset. At the beginning of Year Eleven, the separate corporation housing the hotel business could not distribute $5,000,000 to its shareholders in complete liquidation. Without the diversion of surplus earnings and profits from the brush business, no payments of principal could have been made on the hotel note. The hotel remains fully encumbered. The corporation housing the hotel has nothing of value to distribute. The distribution in Situation No. 2, then, is not analogous to a distribution in complete liquidation. The surplus earnings and profits of the brush business have been temporarily stored in the form of a hotel. They remain surplus earnings and profits of the brush business and should be treated as a dividend when distributed.

Commentators have criticized the safe harbor test of section 346(b) because it fails to insure the genuineness of a contraction and thus allows planned conversion of dividends into distributions that will be entitled to exchange and capital gains treatment.[77] As demonstrated by our analysis of Situation No. 1 and Situation No. 2, this criticism is valid because section 346(b) fails to distinguish between a distribution that could have occurred if the terminated business had been separately incorporated[78] and a distribution that merely represents a distribution of surplus earnings and profits of the nonterminated business. Thus, it invites a corporation to use surplus earnings and profits to purchase or create a separate business for later distribution in an exchange transaction qualifying for capital gains treatment.

The question that logically arises at this point is whether there can be a distribution in partial liquidation that qualifies for exchange treatment when the corporation conducts only one business. Consider three hypothetical distributions made by *X*

76. *See* text accompanying note 23 *supra.*

77. Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revisions,* 14 TAX L. REV. 1, 6-7 (1958).

78. In other words, the distribution must be out of original capital invested in the terminated business and out of earnings and profits, needed in, and generated by, the terminated business.

Corporation.

Distribution No. 1: In Year Twelve and Year Thirteen *X* Corporation paid no dividends, retaining its surplus earnings and profits of those years for planned expansion. The corporation abandoned the plans in Year Fourteen and distributed pro rata to its shareholders the $2,000,000 attributable to the now unneeded expansion reserve.

Distribution No. 2: *X* Corporation operates a clothing store. Because of the advancing age and decreasing ambitions of its principals, *X* Corporation relocates to a smaller location, thereby reducing the scale of its business. A proportionate reduction in both earning capacity and capital needs results, and the corporation distributed pro rata to its shareholders the $2,000,000 attributable to previously needed earnings and profits.[79]

Distribution No. 3: *X* Corporation operates a clothing store. In Year Eleven *X* Corporation discontinues credit sales, reducing its working capital needs by $2,000,000, but leaving its earning capacity and underlying enterprise value unchanged. *X* Corporation distributes the $2,000,000 of previously needed earnings and profits pro rata to its shareholders.

To analogize these distributions to distributions in complete liquidation is inappropriate because *X* Corporation conducts only one business. The appropriate analogy is to sales of shares in a corporation whose existence is not being terminated. The appropriate question is whether the distribution is of surplus earnings and profits or of needed earnings and profits that can only be realized, in the ordinary course of business, by sale.

A dividend is a distribution out of surplus earnings and profits that leaves the shareholder in a position to expect future profits.[80] By contrast, the gain attributable to needed earnings and profits can only be realized by sale of shares, because the distribution of needed assets would reduce the earning capacity of the corporation.[81] Earnings and profits, then, are deemed to be needed, rather than surplus, if their distribution would adversely affect the value of the corporation as a going enterprise.

So viewed, the proper characterization of the distributions in the first and second examples is clear. The distribution of a reserve

79. Compare these facts with those in Estate of Chandler v. Commissioner, 22 T.C. 1158 (1954).

80. *See* text accompanying notes 8-16 *supra*.

81. *Id.*

for expansion,[82] as in Distribution No. 1, would have no impact on underlying enterprise value. A purchaser of shares buys "dividend on" with respect to such retained earnings and profits.[83] Only if the expansion takes place will the reserve be converted into needed earnings and profits.[84] Distribution No. 2, however, does proportionately reduce underlying enterprise value and is, therefore, entitled to exchange treatment.

Distribution No. 3 should be treated no differently from Distribution No. 1. The only difference between these situations is that the corporation attributes Distribution No. 1 to assets that never became a part of the underlying enterprise, but attributes Distribution No. 3 to assets that at one time were a part of the underlying enterprise. The essence of a dividend, however, is a distribution that leaves underlying enterprise value unaffected. Distribution No. 3 is no different from the distribution of any property that is no longer needed in the business and can be distributed without harm to the enterprise.

Despite the soundness of the above conclusion, the corporate-shareholder tax area is so infected with inquiry into intent and purpose,[85] necessitated by the imperfections in the statutory scheme, that one is certain to hear the following objection:

> No bad motive underlay Distribution No. 3. *X* Corporation retained earnings for a legitimate business purpose. They actually used these assets in the business. Surely Distribution No. 3 is different from Distribution No. 1, in which the claimed motive of retaining earnings for future expansion is possibly suspect, and in any event did not result in that expansion.

This focus on motive is wrong. The focus must be the effect of the distribution on the enterprise and the reasonable expectations of investors. An investor who buys *X* Corporation stock for $10 per share, in effect, capitalizes retained earnings to the extent of the purchase price.[86] This investor expects future distribution of sur-

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82. Although no rationale is given, evidence exists of congressional intent not to treat this type of distribution as a partial liquidation. "It is intended that a genuine contraction of the business as under present law will result in partial liquidation . . . . However, a distribution of a reserve for expansion is not a partial liquidation." S. REP. No. 1622, *supra* note 65, at 262.

83. *See* note 21 *supra* and accompanying text.

84. Thus, "needed earnings and profits" are not identical to earnings and profits that can be retained without running afoul of the accumulated earnings tax provisions. Future needs, or the weaknesses of the accumulated earnings tax provisions, might allow the retention of surplus earnings and profits without penalty. These earnings and profits would not thereby become "needed earnings and profits."

85. Bittker & Redlich, *supra* note 2, at 470.

86. *See* text accompanying notes 8-9 *supra.*

plus assets, but not of needed assets, the distribution of which would diminish the earning capacity of *X* Corporation. The assets formerly needed for the credit program are now surplus assets. *X* Corporation is still worth $10 per share. The distribution of the now surplus assets can be characterized either as a windfall profit to *X* Corporation shareholders, or as the type of profit that a shrewd investor might expect to arise occasionally in a properly managed enterprise. In either case, the distribution can be treated as a dividend without damaging the expectations of investors.[87]

The hostility of commentators is based, in part, on their inability to define the "contraction" or "legitimate shrinkage" standard in a meaningful way and in part on their visceral certainty that courts are reaching wrong results in applying this standard. These commentators believe that something is wrong when a distribution attributable to the discontinuance of an unprofitable part of a business is "held a legitimate shrinkage even though the net sales of the corporation were increasing at the time."[88] Application of the above analysis results in dividend treatment for Distribution

87. A discussion of the utility of the phrase "out of earnings and profits" as a part of the definition of a dividend is appropriate at this point. We have already seen that this phrase must be understood as meaning "out of surplus" earnings and profits. *See* text accompanying notes 8-16 *supra.* The real inquiry is whether tbe distrihution is of surplus *assets.* Congress apparently enacted the earnings and profits requirement in 1916 out of concern that corporate distrihutions attributable to presixteenth amendment gains could not be taxed constitutionally. The Supreme Court subsequently decided that this fear was ungrounded and made it clear that dividends under the Revenue Act of 1913 included distributious in the ordinary course of business whether out of earnings or from a mere increase in value of assets. Lynch v. Hornby, 247 U.S. 339, 344-46 (1918). Congress has never expanded the dividend definition to include distributions out of unrealized appreciation, although distributions of appreciated assets out of earnings and profits are dividends.

It often bas been suggested that the earnings and profits requirement should be deleted, or at least amended, to included unrealized appreciation in corporate assets. For thoughtful treatment of this issue, see Andrews, *"Out of its Earnings and Profits": Some Reflections on the Taxation of Dividends,* 69 HARV. L. REV. 1403 (1956); Blum, *The Earnings and Profits Limitation on Dividend Income: A Reappraisal,* 53 TAXES 68 (1975). For the purposes of this Article dividends will be characterized as distributions out of surplus earnings and profits. If the earnings and profits requirement were removed, a dividend would, of course, be a distribution of surplus assets in the ordinary course of business, which would leave underlying enterprise value unaffected.

After Distribution No. 3, the amount realized upon the sale of *X* Corporation stock for $10 per share will be attributable as follows: $1 to invested capital; $7 to needed earnings and profits; $2 to goodwill. As previously noted, the intersection between enterprise value, asset value, and histeric value of the contributed capital and retained earnings accounts would be rare. *See* note 8 *supra.* Thus, a reference to gain, or a portion of a distribution, as attributable to needed earnings and profits is really a reference to the value of the needed assets as a going enterprise, which will often reflect a premium for goodwill.

88. Bittker & Redlich, *supra* note 2, at 472 (footnote omitted).

No. 3 and for distributions attributable to the cessation of unprofitable activities. This analysis also illuminates the underlying rationale that the commentators viscerally feel is misunderstood by the courts and improperly reflected in the statute.

It is suggested, then, that some corporate distributions in partial liquidation should be entitled to exchange treatment. The present section 346 is seriously flawed. The safe harbor of section 346(b) allows planned conversion of ordinary income into capital gains.[89] Moreover, the general rule of section 346(a)(2) provides no standards for determining whether distributions that do not qualify for the safe harbor are "not essentially equivalent to a dividend."

The appropriate test is twofold. First, if a distribution is of assets comprising a separate income producing activity, then exchange treatment is appropriate to the extent the distribution is out of (1) original capital invested in the terminated activity, and (2) earnings and profits needed in, and generated by, the terminated activity. Second, if the distribution is of assets that do not comprise a separate income producing activity, then it must be shown that the distribution is out of previously needed earnings and profits[90] and that the value of the enterprise as a going concern will be reduced by an amount proportionate to the overall reduction in assets.

C. *Redemptions and Section 302*

Extending exchange status to non pro rata distributions in redemption has provoked less concerted attack than extending exchange status to pro rata distributions in partial liquidation. Perhaps this is because the flaw in section 302 is less obvious than that in section 346. Let us evaluate section 302[91] by again considering *X* Corporation and its shareholders.

At the end of Year Eleven *X* Corporation[92] elects to redeem $1,000,000 worth of its outstanding shares rather than to distribute

89. *See* text accompanying notes 76-78 *supra*.

90. Previously needed earnings and profits are to be distinguished from needed earnings and profits. *See* note 84 *supra*. If a corporation is able to replace half of its work force with computerized machinery, thereby reducing its needed earnings and profits, but not adversely affecting the value of the enterprise as a going concern, then any distribution out of the earnings and profits no longer needed is a dividend.

91. This Article evaluates the appropriateness of extending exchange treatment to a shareholder redeemed as a result of a non pro rata distribution but does not address the issue of whether the technical rules should be more or less restrictive.

92. *See* description in Part I *supra*.

this amount as a dividend. If each shareholder tendered ten percent of his shares in exchange for his pro rata share of the distribution, the underlying equity interests of each shareholder would be unchanged. Clearly, as a distribution out of surplus earnings and profits by an ongoing corporation in the ordinary course of business, the distribution should be treated as a dividend,[93] and it would be so treated under current law.[94]

Suppose, however, that *B* and other shareholders tender to *X* Corporation all of their shares, with a total value of $1,000,000, but the remaining shareholders, including *A*, tender no shares. What should be the effect of this transaction? Under section 302, *B* would be entitled to exchange treatment.[95] The question, however, is whether this is appropriate[96] when the distributed assets were attributable to surplus earnings and profits.

Professor Marvin Chirelstein provides a giant step toward the answer in his classic analysis of the effect, and appropriate tax treatment, of non pro rata share redemptions.[97] Chirelstein bases his analysis on the following assumptions. When *X* Corporation[98] makes the redemption, the market values the outstanding shares at $11 per share (ten times earnings plus each share's pro rata share of the undistributed surplus). Thus, *B* receives $110,000 in exchange for his shares, in effect receiving a $10,000 dividend as capital gain under section 302. Moreover, the effect of the redemption is to increase the underlying value of the unredeemed shares by an amount equal to the dividend that they would have received if the redemption proceeds had been distributed pro rata as an ordinary dividend. *A*'s shares, therefore, are still worth $110,000 after the redemption. Under present law *A* may then receive his $10,000 "dividend" when he chooses by selling 1/11 of his shares and receive capital gain treatment of his gain.[99]

Based on this model Chirelstein suggests that a non pro rata redemption should be viewed as a pro rata dividend to all shareholders with the continuing shareholders then using their dividends to purchase the shares of the redeemed shareholders. Thus,

93. *See* text accompanying notes 8-16 *supra*.

94. *See* note 69 *supra*.

95. The Internal Revenue Code extends exchange treatment to a distribution in redemption of all the stock of the distributor owned by the redeeming shareholder. I.R.C. §§ 302(a), 302(b)(3).

96. *See* note 91 *supra*.

97. Chirelstein, *supra* note 2.

98. *See* description in Part I *supra*.

99. *See* Chirelstein, *supra* note 2, at 740-41.

A and *B* would each be treated as receiving a $10,000 dividend. *A* would then be treated as purchasing a portion of the redeemed shares worth $10,000, giving him shares worth $110,000. *B* would be treated as selling his shares for $100,000, producing no gain or loss.[100]

The case for imputing a dividend to continuing shareholders is compelling. The case for imputing a dividend to a redeemed shareholder is less so. Our analysis suggests that a distribution out of surplus earnings and profits by an ongoing corporation in the ordinary course of business should be a dividend.[101] Thus, a portion of *B*'s redemption proceeds can be attributed to surplus earnings and profits and, therefore, viewed as a dividend. If, however, *B* had sold his shares to a new investor for $110,000 instead of tendering them for redemption, a portion of the sale's proceeds would also be attributable to *B*'s pro rata share of then undistributed earnings and profits. If, as our analysis suggests, *B*, when selling his shares, is properly entitled to exchange treatment in full,[102] then equity requires that *B*, when tendering his shares for redemption, receive the same treatment.[103]

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100. *Id.* at 752-53.

101. *See* text accompanying notes 8-16 *supra.*

102. *See* text accompanying notes 17-21 *supra.*

103. It has recently been asserted that distributions in redemption are not analogous to sales to new investors, even when looking at the effect on the distributee alone, because "a redemption distribution delivers assets free from the prospective burden of corporate income tax on their earnings, while a sale of shares to a noncorporate purchaser only delivers an interest in those assets subject to that burden." ALI TAX PROJECT, *supra* note 3, at 113. The critical assumption in this assertion is that the productive assets of a corporation can be operated in partnership form as efficiently as in corporate form. If one accepts this propositon, then a shareholder would prefer to receive the income from the asset without first paying a corporate tax on such income.

The assumption is untenable, however. If General Motors distributed productive assets, such as a truck division, in redemption of 10% of it sbares, it is doubtful that the million new partners would be able to operate the business at all. Even if this were possible, it is likely that the additional legal and accounting costs would eliminate the advantage gained. Smaller enterprises might be able to avoid the prospective burden of the corporate tax by distributing productive assets to shareholders. Presumably, however, such enterprises operate as partnerships or as corporations under a Subchapter S election. Moreover, sales or redemptions of the shares of closely-held corporations will often be at a price that reflects underlying asset value. Investors in these enterprises do not contemplate indefinite life for the corporation and may not expect any dividends during its life. The income stream may be paid out monthly as salaries, thus avoiding the corporate tax. Thus, a shareholder will not willingly sell for a price that reflects a prospective burden to which the assets are only temporarily, and while to the advantage of the shareholders, subjected.

The assumption also is that productive assets will be distributed. Except in complete liquidations, however, a corporation will retain productive assets and only distribute surplus assets that it cannot invest more profitably than its shareholders.

It is true that a selling *B* will be replaced by a new investor who will later receive the surplus earnings and profits as a dividend, whereas the redeemed *B* will be replaced by no new investors. This fact, however, does not require treating a redeemed *B* differently from a selling *B*. Rather it suggests that *B* is replaced by continuing shareholders who should be treated as receiving their respective pro rata shares of the entire distribution.

A critical assumption made by Chirelstein is that the market value will fully reflect the undistributed surplus earnings and profits. A perfectly functioning market, however, would discount the value of the undistributed surplus because of the uncertainty of distribution and the tax to be paid on the prospective dividend.[104] Thus, if the true value of the underlying enterprise is $10 per share, the price at the time of redemption would be more than $10, but less than $11, per share. Consequently, Chirelstein bases his conclusions on the unrealistic assumption that share price in a perfect market will fully reflect the amount of undistributed surplus. Consider the implication of the equally unrealistic assumption that the market will attach no value to increase or decrease in surplus.

Under this assumption the market would value *X* Corporation at $10 per share before the redemption and at $11.1111 per share after the redemption.[105] When redeemed for $100,000, *B* only recovers his $100,000 investment and receives no benefit analogous to a dividend. The total value of *A*'s shares, however, increases as a result of the redemption from $100,000 to $111,111. *A* has an actual gain equal to his pro rata share of the distributed surplus that can be viewed as a dividend.

If, as should be the case in a perfect market, the price of *X* shares partially reflects undistributed surplus, it is necessary to determine how nonredeemed shareholders should be treated. The nonredeemed shareholders will receive a greater benefit than the redeemed shareholders in terms of immediately realizable gain in the form of increased share value, although slightly less than their pro rata share of the total distribution. Moreover, the taxation of continuing shareholders in this manner will remove any incentive

104. *See* text accompanying notes 18-21 *supra*. *See generally* Cohen *et al., supra* note 2, at 23; Kingson, *The Deep Structure of Taxation: Dividend Distributions,* 85 YALE L.J. 861, 863-65 (1976).

105. The $1,000,000 distribution would result in the repurchase of 100,000 shares. *X* Corporation would continue to be valued by the market at ten times earnings or at a total value of $10,000,000. *A* owns 1/90 of the outstanding shares after the redemption, which have a total value of $111,111.

for corporations to undertake share redemptions absent demonstrable corporate benefit flowing from the transaction. If this benefit can be demonstrated, then presumably the market price slightly undervalues the corporation in comparison to its worth after such benefit is obtained through the redemption.[106]

Chirelstein's argument suffers as a result of his failure to distinguish between distributions out of surplus earnings and profits and those out of needed earnings and profits.[107] His analysis becomes more compelling when this flaw is removed.[108] It is then clear that section 302 treatment of redeemed shareholders is analogous to the treatment of one who sells to new investors, and thus, is appropriate. Surplus earnings and profits, however, have been distributed and a dividend should be imputed, but only to the nonredeemed shareholders.

D. *Bootstrap Acquisitions*

A major consequence of the flaws in sections 302 and 346 is the bootstrap acquisition bailout device.[109] A bootstrap acquisition is one in which a major shift in share ownership is accomplished, at least in part, through a distribution of corporate assets.[110] The distribution may be in the form of a dividend or a redemption. Its effect, necessarily, is to lessen the amount of money that the purchaser or continuing shareholder would otherwise have to pay to the seller. This situation raises the question of whether the seller should be treated as receiving a dividend or be afforded exchange treatment with respect to the corporate distribution. One must also ask whether the purchaser or continuing shareholder should be treated as receiving a constructive dividend in an amount equal to the distribution received by the seller.[111]

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106. Chirelstein finds no corporate benefits flowing from a redemption that could not equally be obtained by dividend. Chirelstein, *supra* note 2, at 741-47. Arguably, redemptions that remove a troublesome minority interest or that enable a corporation to "go private" would provide demonstrable benefit to the corporation. Obviously neither of these benefits could be obtained by dividend.

107. *Id.* at 749.

108. For another view of the flaw in Chirelstein's thesis, see Bacon, *Share Redemptions by Publicly Held Companies: A New Look at Dividend Equivalence,* 26 TAX L. REV. 283 (1971).

109. For a good description of this device, see Clark, *supra* note 5, at 113-14.

110. For two views of this problem, see Ginsburg, *Letter to the Editors,* 86 YALE L.J. 798, 800-05 (1977); Jassy, *The Tax Treatment of Bootstrap Stock Acquisitions: The Redemption Route vs. the Dividend Route,* 87 HARV. L. REV. 1459 (1974).

111. While Professor Chirelstein believes that Congress has made no policy choice against imputing dividends as a result of share redemptions by public corporations, he be-

The case law suggests certain generally predictable results of a bootstrap acquisition. If the seller receives a corporate distribution in redemption of some of his shares, exchange treatment can be expected. If the seller receives the distribution in the form of a dividend, he may still receive exchange treatment with respect to the distribution if it constitutes a constructive dividend to the purchaser or continuing shareholder. Whether the distribution is in the form of a dividend or redemption, the purchaser will receive a constructive dividend if the "distribution relieves him of an existing primary and unconditional obligation to acquire the subject stock."[112] Even if no such obligation is removed, a distribution in the form of a dividend may be imputed to the purchaser or continuing shareholder if the purchaser was the beneficial owner of the purchased shares at the time of dividend declaration or if the dividend was "an essential step in a bootstrap acquisition plan."[113]

The existing case law places a premium on form, rather than substance.[114] This approach is understandable in view of the general misperception of what, in substance, is a dividend. Our analysis, however, suggests that the appropriate consideration is whether the distribution is of surplus earnings and profits or of needed earnings and profits. This is an appropriate starting point to attempt to clarify the bootstrap acquisition problem.

Suppose that *A* and *B* each own fifty per cent of the shares of *X* Corporation.[115] At the beginning of Year Eleven *X* Corporation redeems *B*'s shares for $5,000,000.[116] Alternatively, assume that *A*

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lieves the contrary to be true with respect to closely-held corporations. Chirelstein, *supra* note 2, at 750. He suggests that § 302 must be deemed to reflect a basic and presently unchallengeable congressional policy to extend capital gains treatment to redemptions by closely-held corporations in order "to facilitate occasional, and often major, shifts in ownership interests among the shareholders of closely-held or family-owned corporations for whose shares no active market exists apart from the company itself." *Id.* The accumulated earnings tax provisions, however, indicate that Congress has never intended to allow closely-held corporations to retain surplus earnings and profits. Thus, it cannot be seriously suggested that Congress has manifested an intent to allow significant amounts of surplus earnings and profits to be converted into capital gains as a means of facilitating shifts of control. Moreover, the profusion of bootstrap acquisition cases indicates a visceral agreement by courts and the Service with the proposition that the policy underlying § 302 requires, in a proper case, imputing a dividend to the nonrecipient beneficiary of a closely-held corporation's distribution.

112. Jassy, *supra* note 110, at 1476.

113. *Id.* at 1475-76.

114. *See* B. BITTKER & J. EUSTICE, *supra* note 26, at ¶ 9.25; Ginsburg, *supra* note 110.

115. *See* description in Part I *supra.*

116. Assume that the corporation distributed annual earnings of $1,000,000 as a dividend at year end.

owns 100 per cent of the shares, *B* purchases fifty per cent for $5,000,000, and *X* Corportion redeems the remainder for $5,000,000. Before the redemption *X* Corporation has no surplus assets and must, therefore, borrow $5,000,000 in order to accomplish the redemption.[117]

The distribution is out of needed earnings and profits and contributed capital and thus, should not be characterized as a dividend in either case.[118] Indeed, this distribution constitutes a partial liquidation and should be so treated under a properly designed section 346.[119] Unlike a non pro rata distribution of surplus assets, a distribution out of needed earnings and profits provides no basis for imputing a dividend to the nonrecipient. Here, the lender is substituted for *B* and has a prior and substantial call on future profits. There has been a decrease in underlying enterprise value at the shareholder level in an amount roughly equal to the value of the distribution. *B* has received nothing that can be viewed as a dividend.

Suppose that we vary our hypothetical bootstrap acquisition in one respect. *X* Corporation has an underlying enterprise value of only $5,000,000, attributable to contributed capital of $1,000,000 and needed earnings and profits of $4,000,000, and has surplus earnings and profits of $5,000,000.[120] The distribution in redemption of *A*'s shares now comes entirely out of surplus earnings and profits. The above analysis suggests that *A* should be entitled to exchange treatment, but that a dividend should be imputed to *B* in

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117. This example assumes, as Chirelstein suggests, that no one could be found who would purchase all of the shares.

118. This characterization is consistent with the definition of a dividend as a distribution out of surplus earnings and profits.

119. It is a partial liquidation because the corporation distributes needed earnings and profits, which results in a proportionate drop in underlying enterprise value. *See* text accompanying notes 79-90 *supra.* Thus, a partial liquidation involves a "contraction" at a given point in time, regardless of whether the corporation is able or intends to grow later. Real, measurable, proportionate decrease in enterprise value caused by distribution of needed earnings and profits is the standard. Use of terms such as "contraction," leads to confusion on this point and makes analysis difficult. *See, e.g.,* Cohen *et al., supra* note 2, at 37.

120. This hypothetical will remind the reader of the facts in Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). In *Zenz* the court considered the issue of whether

> a distribution of substantially all of the accumulated earnings and surplus of a corporation, which are not necessary to the conduct of the business of the corporation, in redemption of all outstanding shares of stock of said corporation owned by one person, [is] essentially equivalent to the distribution of a taxable dividend under the Internal Revenue Code.

Id. at 915. The court, in holding that it was not, reached, in my opinion, an incorrect result.

the amount of the distribution.[121]

Bootstrap acquisitions, then, would present no conceptual or practical problem under properly designed sections 302 and 346. Section 302 would apply to distributions attributable to surplus earnings and profits and would impose a dividend consequence on purchasers or continuing shareholders to the extent the redeemed shareholders qualified for exchange treatment. Section 346 would apply to distributions attributable to needed earnings and profits and would not impose a dividend consequence on continuing shareholders.

V. Corporate Separations

A detailed treatment of corporate separations is, of course, beyond the scope of this Article.[122] The problems associated with partial liquidations and corporate separations are, however, closely linked.[123] It is submitted that treating partial liquidations as suggested in this Article would allow a simple and fair resolution to the problem posed by a corporate separation.

In the archetypical corporate separation a corporation places the assets of one of its businesses in a subsidiary and distributes the shares of the subsidiary pro rata to its shareholders. The transaction is in the form of a dividend, and is literally out of earnings and profits.[124]

Congress has struggled to draw a line between a good separation and a bad one. If the assets placed in the subsidiary are those of an active business, and if the separation is motivated by business purpose or necessity, the transaction is thought to effect

121. *See* analysis in Part IV, Section C *supra*. If a dividend is imputed to *B*, he will, of course, require that the redemption price be set at an amount, lower than $5,000,000, which will compensate *B* for the cost of the imputed dividend.

122. For the definitive article on the history and present treatment of corporate separation, see Whitman, *Draining the Serbonian Bog: A New Approach to Corporate Separations Under the 1954 Code*, 81 Harv. L. Rev. 1194 (1968).

123. *See* Surrey, *supra* note 77, at 9.

124. There are three types of corporate separations—spin-offs, split-offs, and split-ups. In a spin-off or split-off a corporation first places some of its assets in a subsidiary corporation or purchases a corporation. In a split-off the parent company is a mere holding company. In a spin-off the shares of the subsidiary are distributed as a dividend, but in a split-off the shares of the subsidiary are distributed in redemption of shares of the parent. In a split-up the shares of the subsidiaries are distributed in complete liquidation of the parent. The effect of each type of corporate separation is the same. The shareholders of the former parent now hold shares in more than one corporation. No corporate assets have left solution. Thus, the shareholders now have a direct interest in two corporate baskets, but the total content equals that of the former basket.

merely a change of form and to be of insufficient magnitude to constitute a taxable event.[125] If, however, the assets placed in the subsidiary are liquid assets that should be distributed as a dividend, then the distribution should be treated as a dividend. Otherwise, the separation would soon be followed by a complete liquidation of the spun-off subsidiary that would convert ordinary income into capital gain.[126] The crux of the problem, then, is the need to allow legitimate corporate separations but prevent conversion of ordinary income into capital gain. The present treatment of corporate separations, however, is a web of uncertainty.

The statute presents three significant hurdles. Each of the corporations previously housed under one umbrella must be engaged in the active conduct of a trade or business immediately after the distribution.[127] The trade or business must have been actively conducted throughout the five-year period ending on the date of distribution.[128] The transaction must not have been "used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both."[129] In addition, the Internal Revenue Service attempts to test each transaction to determine if it is motivated by a legitimate business purpose.[130]

The active business test has been attacked[131] because of the definitional uncertainties and because of its irrelevance to the basic problem of determining whether a transaction is being used to convert dividend income into capital gain.[132] The device test is criticized because it requires an inquiry into motive and a predic-

125. For instance, the divestment by a corporation that has long operated two active businesses of one of the businesses as a result of antitrust litigation would not be considered a taxable event. *See* Proposed Treas. Reg. § 1.355-2(b)(2), Example 1, 42 Fed. Reg. 2695 (1977).

126. The classic case is Gregory v. Helvering, 293 U.S. 465 (1935). Gregory was the sole shareholder of *X* Corporation, which owned marketable securities. Rather than distribute these as a dividend, the corporation placed the securities in a newly created subsidiary, the shares of which were spun off to Gregory. The transaction literally constituted a reorganization under the Revenue Act of 1928. Three days after the spin-off, the subsidiary was liquidated and the securities sold. Gregory reported her gain as capital gain. *Id.* at 467. Because no business purpose existed, the Court refused to honor the form of the transaction and treated the spin-off as a taxable dividend. *Id.* at 469-70.

127. I.R.C. § 355(b)(1).

128. I.R.C. § 355(b)(2)(B).

129. I.R.C. § 355(a)(1)(B).

130. Proposed Treas. Reg. § 1.355-2(b), 42 Fed. Reg. 2695 (1977).

131. This criticism does not apply in dealing with the liquid asset case presented by *Gregory. See* note 126 *supra.*

132. *See* Surrey, *supra* note 77, at 10; Whitman, *supra* note 122, at 1210-11.

tion of future behavior, both of which are tricky propositions.[133] The business purpose inquiry is also irrelevant when the basic question is whether conversion of dividend income into capital gain will occur.[134]

The appropriate standard appears quite simple. Each separation should be tested to determine whether the assets of the separated corporations could have been directly distributed to the shareholders in a transaction qualifying for capital gains treatment. The separation would thus be required to satisfy section 302 or 346.[135] The Service would have little difficulty with such a rule for a non pro rata separation.[136] The problem lies with section 346. The Service cannot allow a safe harbor for transactions that could qualify under section 346, because section 346(b) allows planned conversion of surplus earnings and profits into capital gain.[137]

Consider *X* Corporation as previously described in Situation No. 2.[138] The present section 346(b) would extend exchange treatment to the pro rata distribution of the hotel business described in Situation No. 2, despite the fact that its entire value is attributable to surplus earnings and profits of the continuing business. The Service is obviously unwilling to extend a safe harbor to pro rata separations on the basis of their ability to qualify under section 346(b).

It is evident that a problem exists with present section 355. One suggested cure has been to "taint" the spun-off stock, either for some fixed period of time[139] or permanently.[140] If the taint is for a fixed period of time, then disposition after a specified period of time could be made as capital gain. The only effect of a limited taint, then, is to lengthen the amount of time involved in planned

133. Cohen, *Reconciling Business Purpose with Bail-out Prevention: Federal Tax Policy and Corporate Divisions*, 28 STAN. L. REV. 1077, 1088 (1976).

134. *Cf.* Bales, *The Business Purpose of Corporate Separations*, 56 VA. L. REV. 1242 (1970) (Bales suggests that the business purpose doctrine may have some vitality in spite of § 355).

135. Of course, a simple active business requirement is also required to deal with pure liquid asset cases like *Gregory*. *See* note 126 *supra*.

136. The Proposed Income Tax Regulations state that "in any case in which a distribution with respect to each distributee would be treated as a redemption to which § 302(a) would apply if it were taxable, the transaction is ordinarily not considered to be a device for the distribution of earnings and profits." Proposed Treas. Reg. § 1.355-2(c)(1), 42 Fed. Reg. 2695 (1977).

137. *See* notes 78-79 *supra* and accompanying text.

138. *See* text accompanying notes 75-76 *supra*.

139. *See* Whitman, *supra* note 122, at 1250.

140. *See* Cohen, *supra* note 133, at 1098-99; Surrey, *supra* note 77, at 13.

conversion of dividend income into capital gain. If, however, the taint is permanent, then dividend treatment in the future may be imposed on transactions that could have qualified for capital gain treatment if taxed at the time of distribution.

Recognition of the inherent flaw in section 346 is a prerequisite to curing the basic defects in section 355. If section 346 is redesigned[141] to prevent the conversion of dividend income into capital gain, then section 355 can be simplified by eliminating the "device," "business purpose," and five-year active business requirements. All that should be required is that the distributing and spun-off corporations each be engaged in an active business, and that tbe assets of each corporation could be directly distributed in a transaction that would qualify for capital gains treatment under either section 302 or 346.

VI. THE LIQUIDATION-REINCORPORATION BAILOUT

The failure of Congress to attach a dividend consequence to the portion of a liquidating distribution that is out of surplus earnings and profits[142] makes possible the liquidation-reincorporation bailout.[143] Assume that *X* Corporation has a substantial accumulation of surplus earnings and profits and is, therefore, concerned about the accumulated earnings tax. Although Congress clearly desires that these surplus earnings and profits be distributed as a dividend,[144] a corporation with surplus earnings and profits will often be "liquidated." The shareholders of the old corporation retain the surplus assets, but the operating assets are contributed to a newly formed corporation that continues to operate the business.[145] This enables the shareholders of the old corporation to extract the surplus earnings and profits in a transaction that on its face qualifies for exchange, and capital gain, treatment.

141. *See* proposal accompanying notes 89-90 *supra*.

142. *See* text accompanying notes 23-27 *supra*.

143. For a detailed discussion of the possible forms and advantages of tbe liquidation-reincorporation device, see Clark, *supra* note 5, at 125-30. We are interested here only in a bare outline of the problem and an indication of the necessary solution consonant with the underlying principles. For an in-depth analysis of the present law, see Hjorth, *Liquidations and Reincorporatons—Before and After* Davant, 42 WASH. L. REV. 737 (1967); Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964).

144. *See* text accompanying notes 8-16 *supra*.

145. Alternatively, the operating assets may be sold to the new corporation by the old corporation, which then distributes the surplus earnings and profits and the proceeds of the sale of the operating assets to the shareholders of the old corporation.

The Service has resolutely challenged liquidation-reincorporation transactions, attempting to characterize them as sham liquidations, or as reorganizations under section 368(a)(1)(D), (E), or (F). If substantial or complete identity exists between the shareholders of the old and new corporations the Service has been reasonably successful in persuading courts that such transactions constitute reorganizations accompanied by the distribution of boot taxable as a dividend. If, however, a court finds an insufficient continuity of interest or is unable or unwilling to engage in the mental gymnastics necessary to recharacterize a particular transaction, taxpayers are successful.[146]

The focus of the analysis by the Service and courts in a liquidation-reincorporation should be whether or not surplus earnings and profits are being removed from the corporation.[147] The transaction should be characterized as a dividend if and to the extent that surplus earnings and profits are removed; if not, exchange treatment is appropriate. An analysis that entails inquiry into the subsequent use made of the operating assets distributed, the business purpose for the transaction, and the amount of continuity of interest between shareholders of the old and new corporation is clumsy and utilizes inappropriate tools that are certain to promote taxpayer uncertainty and case law chaos.

Suppose that hypothetical *Z* Corporation distributes assets with a book and fair market value of $10,000,000 to its two shareholders, *A* and *B*, who immediately form New Corporation in a different state and contribute the assets formerly owned by *Z* Corporation to New Corporation. The assets distributed by *Z* Corporation were attributable solely to needed earnings and profits and contributed capital. Accordingly, *A* and *B* should be entitled to exchange treatment of the liquidating distribution, since no surplus earnings and profits were distributed. Suppose, instead, that one-

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146. *See* B. Bittker & J. Eustice, *supra* note 26, at ¶ 14.54.

147. It is often asserted that a liquidation-reincorporation should also be sanctioned if its purpose is to achieve a step-up in the basis of operating assets. Suppose a corporation has operating assets with a fair market value of $20,000,000 and a basis of $10,000,000. Should the shareholders of the corporation be able to liquidate it and reincorporate, thereby stepping-up the basis of the operating assets to $20,000,000? Why should continuing shareholders be denied a step-up that would be available to new investers who purchased these assets? Is the real concern the step-up in basis or the avoidance at the corporate level of a tax on the gain inherent in the operating assets? This aspect of the liquidation-reincorporation problem is beyond the scope of this Article. For a thorough analysis and suggested approach, see ALI Federal Income Tax Project: Subchapter C Corporate Distributions (Tent. Draft No. 1, 1977).

half of *Z* Corporation's liquidating distribution is of surplus earnings and profits. To that extent, the distribution should be treated as a dividend.

The form, business purpose, and continuity of interest of these two transactions are identical. The substance, however, is different. Revising section 331 to characterize distributions in complete liquidation as a dividend to the extent of out-of-surplus earnings and profits would prevent a liquidation-reincorporation transaction from being used to bail out dividends as capital gain[148] and would provide a means for distinguishing between a good liquidation-reincorporation transaction and a bad one.

VII. CONCLUSION

Much of the confusion and complexity in the present system of taxing corporate distributions can be traced to the mistaken view that earnings and profits, in toto, constitute a reservoir from which future dividends will flow. An analysis of the origin and development of the present system suggests, instead, that a distribution should be treated as a dividend to someone, although not always the recipient, only to the extent that it is out of surplus earnings and profits. To the extent a distribution is instead out of needed earnings and profits it should be treated as received in exchange for the shares actually or constructively redeemed. Further, the problems and complexities in the present Internal Revenue Code section 355 can be traced directly to the flaws that exist in sections 302 and 346. The problems and complexities in section 355 could be eliminated if sections 302 and 346 accorded dividend treatment only to distributions of surplus earnings and profits and accorded exchange treatment only to distributions of needed earnings and profits.

It is important to realize that it is possible to perfect the present system in a way capable of fair, accurate, and efficient administration. This could be accomplished by amending the present

148. One cannot help but feel that many judicial decisions in this area can only be understood as representing the court's viscereal understanding of the result required by underlying policy. For example, in the oft-discussed Gallagher v. Commissioner, 39 T.C. 144 (1962), the court refused to recharacterize a liquidation-reincorporation as a reorganization accompanied by a distribution of boot. The court acknowledged the existence of valid business purpose and continuity of business enterprise, *id.* at 157, but respected the literal, integrated form of the transaction, which resulted in an insufficient continuity of shareholder interest. *Id.* at 157, 163. One must wonder how much the court was influenced by the fact that none of the assets distributed were surplus assets.

Code to establish a statutory presumption that a distribution of corporate assets is out of surplus earnings and profits, except to the extent the taxpayer can show, by clear and convincing evidence, that the distribution is out of needed earnings and profits. The legislative history accompanying the amending legislation could use examples, such as those presented in this Article, to demonstrate which distributions Congress intended to be treated as out of surplus earnings and profits and which it intended to be treated as out of needed earnings and profits. The legislative history would indicate that a distribution would not constitute a distribution of needed earnings and profits unless it materially and in reasonable proportion to its value effected a reduction in underlying enterprise value, as opposed to a mere reduction in net asset value.

Recognition of the bifurcated nature of earnings and profits and the true nature of a dividend suggests further reform of the present system. Because earnings and profits constitute only a historical measure of the undistributed earnings of a corporation and reflect neither appreciation in the value of assets nor underlying enterprise value, any distribution of surplus assets should be a dividend, and any distribution of needed assets should be treated as in exchange for shares actually or constructively redeemed, without regard to the status of the earnings and profits account.[149]

Moreover, an understanding of the bifurcated nature of earnings and profits and of the correct line between a dividend and a distribution that is entitled to exchange treatment, is important because it provides a starting point for meaningful consideration of broader reform of the present system. These distinctions demonstrate to those who favor treating all corporate distributions as dividends that the only appropriate remedy is to eliminate the capital gains preference, not only for corporate distributions but also for gains on sales of shares in the market. This is so because a sale of shares is merely a way of realizing the gain represented by needed earnings and profits. This Article has suggested the steps to be taken by any reform effort concerned with drawing the appropriate line between distributions that are dividends and those that are entitled to exchange treatment.

Finally, and perhaps most importantly, an understanding of the underlying rationale of the present system reveals the great inconsistencies between the system's effects and that basic rationale.

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149. *See* note 86 *supra*.

Realization of the discrepancy should motivate the Service and the courts to bend the present system to a shape that comports as much as possible with its underlying principles.