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A Different Look at the Taxation of Corporate Distribution and Shareholder Gain

Charles O'Kelley

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The taxation of corporate distributions and shareholder gain is an area of the Internal Revenue Code which has fostered a seemingly never-ending yet never-successful attempt by the Courts and Congress to design a coherent, non-discriminatory regime. In this article, Mr. O'Kelley sets forth a proposal for a logical system for treating corporate distributions to shareholders which would strengthen the double tax scheme, and eliminate its present loopholes.

The present scheme of corporate-shareholder taxation subjects a corporation's taxable income to the corporate tax.[1] The after-tax earnings of the corporation may be accumulated provided the corporation is not a personal holding company[2] or is not subject to the accumulated earnings tax.[3] Upon distribution of a corporation's after-tax earnings in the form of a dividend, each non-corporate recipient shareholder includes in his or her gross income the dividend's fair market value.[4]

The burden of this double taxation of the gain recognized by a corporation may be greatly reduced if the distribution qualifies as a redemption under section 302(a) of the Internal Revenue Code, as a partial liquidation under section 331(a)(2), or as a complete liquidation under section 331(a)(1). Such distributions are treated as being in part

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1. Pursuant to I.R.C. § 11 corporate earnings are subject to a flat rate tax at the corporate level. For taxable years ending after December 31, 1974 and before January 1, 1979, § 11 provides for a tax equal to the sum of (1) 20% of the portion of taxable income not in excess of $25,000, (2) 22% of the portion of taxable income in excess of $25,000, but not in excess of $50,000, and (3) 48% of the portion of taxable income in excess of $50,000.
2. I.R.C. §§ 541-547.
3. I.R.C. §§ 531-537.
4. I.R.C. §§ 301, 316. The first $100 of a dividend may qualify for exclusion. I.R.C. § 116.

or full payment in exchange for the stock of the recipient shareholder, and the shareholder is, therefore, entitled to capital gains treatment for any gain, rather than being required to include in his or her gross income the distribution's value.[5] Concerning complete liquidations, Code section 337 allows a further reduction in the burden of the double-tax system by exempting from the corporate tax most gain recognized by a corporation after the adoption of a plan of complete liquidation. Likewise, Code sections 311 and 336 exempt a corporation from taxation of the appreciation in value of its property if such property is distributed to its shareholders with respect to its stock or in partial or complete liquidation. Together, sections 311, 336, and 337 provide significant opportunities for a corporation to avoid taxation on the appreciation in value of its assets.

These present provisions discriminate against continuing corporations,[6] and Congress has been unable or unwilling to eliminate this inequity by strengthening the double tax system.[7] For instance, Code section 341 requires that a shareholder's gain from the liquidation of a "collapsible corporation" shall be treated as ordinary income. A "collapsible corporation" is one used by its shareholders for the purpose of converting ordinary income into capital gains.[8] From section

5. Capital gains and losses are governed by I.R.C. subch. P. Stock normally will be a capital asset under I.R.C. § 1221. I.R.C. § 1222(3) defines long term capital gain as "gain from the sale or exchange of a capital asset held for more than 6 months [9 months for taxable years beginning in 1977; 1 year for taxable years beginning after December 31, 1977]." Net capital gains are taxed more favorably than ordinary income under I.R.C. §§ 1201 and 1202. The exact extent of the preference resulting from capital gains treatment over ordinary income treatment depends on the application of the minimum tax provisions of I.R.C. §§ 56-58 and to the circumstances of each taxpayer.

6. The phrase "continuing corporation" is used in this article to refer to corporations which, assuming their business is successful, are not formed or availed of with a view to liquidation, and are operated in a manner which periodically results in the payment of corporate tax by the corporation and income tax on dividends by the shareholders. The antithesis of a continuing corporation is a collapsible one. *See* note 8, *infra.*

7. In the judgment of one commentator:

> [These sections] hardly pay lip service to the 'double-tax system.' Congress has sawed off the tailgate of the corporate tax wagon. In so doing, it has weighted the tax system in favor of business liquidators and traders and against continuing owners. The latter are exposed to the double tax; the former (provided they escape that erratic policeman, the 'collapsible corporation' provision) are not.

JAMES B. LEWIS, A PROPOSED NEW TREATMENT FOR CORPORATE DISTRIBUTIONS AND SALES IN LIQUIDATION, HOUSE COMM. ON WAYS AND MEANS, COMPENDIUM OF PAPERS ON BROADENING THE TAX BASE, 86th Cong., 1st Sess. 1644-45 (1959).

8. According to I.R.C. § 341(b)(1), a

> collapsible corporation is a corporation formed or availed of principally for the manufacture, construction or production of property, for the purchase of property . . . or for the holding of stock in a corporation so formed or availed of, with a view to —
>
> (A) the sale or exchange of stock by its shareholders (whether in liquidation or otherwise), or a distribution to its shareholders, before the realization by the corporation . . . of a substantial part of the taxable income to be derived from such property, and
>
> (B) the realization by such shareholders of gain attributable to such property.

341, it is clear that Congress felt a corporation must be used for more than the conversion of ordinary income into capital gains.[9] While commentators have argued that the only difference between a "collapsible" and other corporations is that the former was established with liquidation in mind,[10] it is probable that almost all corporations are formed with a view to this possibility.[11] Thus, by focusing on a narrow problem, the collapsible corporation provision attacks only a small number of the areas where corporate liquidators are favored over continuing corporations. As with section 341, other Code provisions[12] collectively demonstrate that Congress, when faced with the reality of blatant conversion of ordinary income into capital gains, has moved to plug the hole. In each instance, however, an emphasis on the immediate problem may have blinded Congress to the fact that after each hole has been repaired, the continuing corporation is still discriminated against.

One way to eliminate this discrimination would be to provide that all distributions by a corporation to its shareholders and all gain realized by a shareholder upon the sale of his or her stock would be treated as ordinary income or that all such gains would be treated as capital gains.[13] However, major philosophical and practical considerations would be faced by Congress if it considered ending the capital gains preference.[14] This article solely concentrates on the problems which the

9. Abuse in this area became apparent in the motion picture industry. *See* O'Brien v. Commissioner, 25 T.C. 376 (1955).

10. Bittker and Redlich, *Corporate Liquidations and the Income Tax*, 5 TAX L. REV. 437, 439 (1950).

11. The incorporators will be concerned about whether to issue § 1244 stock in order to preserve the possibility of ordinary loss in the event the corporation is unsuccessful, about the possibilities of putting in some of their investment as debt to protect them in relation to outside creditors in the event of bankruptcy, and about the various possibilities of terminating their investment at low tax cost. *See* Costello v. Fazio, 256 F.2d 903 (9th Cir. 1958), for an excellent discussion of the issues involved when a bankruptcy court attempts to subordinate the claims of shareholders of a failed venture. Most taxpayers will submit to the corporate form only after taking a good look at all possible tax consequences including liquidation, and will conduct its corporate affairs in a manner likely to minimize its ultimate tax burden.

12. *See* I.R.C. §§ 305, 306, 302(b) and 318.

13. I.R.C. § 331 provides that amounts distributed in partial or complete liquidation of a corporation shall be treated as payment in exchange for stock. I.R.C. § 302 provides that amounts distributed in a qualified redemption shall be treated as payment in exchange for stock. Under I.R.C. subch. P, such gains are entitled to capital gains treatment. Under I.R.C. § 301 the amount of dividend distributions is included in the gross income of the recipient, and therefore is subject to taxation at ordinary income rates. Because of this advantage resulting from the successful characterization of a distribution as being in redemption or in partial or complete liquidation, as opposed to its characterization as a dividend, much tax planning and litigation has its origin in the attempt to cloak a corporate distribution in other than the form of a dividend. If the capital gains preference is eliminated, then the importance of such characterizations will be greatly reduced as will be the discrimination against continuing corporations.

14. The major reasons for and against preferential tax treatment of capital gains are summarized in Blum, *A Handy Summary of the Capital Gains Arguments*, 35 TAXES 247 (1957). *See*

preference creates within the corporate tax scheme and suggests that such difficulties can be obviated without terminating the capital gains preference in its entirety. Thus, a major focus is the development of a logical system for determining when capital gains treatment is to be afforded to a shareholder upon his or her receipt of a corporate distribution with respect to, or in exchange for, his or her stock.

A proposal is set forth for treatment of corporate distributions to shareholders which is based on the promise that continuing corporations and its shareholders should be favored by the tax laws rather than temporary corporations. The proposal is based on the assumption that the double taxation of corporate gain is the desired system,[15] that shareholders normally should receive corporate distributions as dividends treated as ordinary income, but that in some cases the gains realized by shareholders upon their receipt of distributions in redemption, or in partial or complete liquidation, should be entitled to capital gains treatment rather than as ordinary income. Thus, there is no attempt to consider the relative merits of various integration proposals as opposed to the double tax system or the comparative advantages of preferential as opposed to ordinary tax treatment of capital gains. Instead, this article seeks to develop a proposal which strengthens the double tax system by affording preferential treatment of shareholder gain on corporate distributions in redemption or liquidation only to shareholders whose corporations ("Fully Qualified Corporations" or "Fully Qualifying Corporations") have been operated in a manner, justified by its dividend history, to qualify its shareholders for such preferential treatment.

First, this article offers a proposed test for determining whether a corporation is Fully Qualified. Next, we develop and test the proposal

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also TREASURY TAX STUDY, FEDERAL INCOME TAX TREATMENT OF CAPITAL GAINS AND LOSSES (1951). Though the Carter administration apparently will recommend the abolishment of the capital gains preference, Boston Globe, Sept. 25, 1977, at C1 col. 2; TIME, Sept. 26, 1977, at 85, it is impossible to predict whether Congress will concur. Certainly, there will be stiff opposition to such proposal based upon the need for such treatment to foster capital investment. One reason given for preferential treatment of capital gains is that it compensates for the distortion to an individual's tax burden resulting from the lumping of a capital gain entirely into one year and compensates for the unfairness of taxing as gain what is, in reality, only inflation. Another problem with eliminating the preferential treatment of capital gains is the fear that such will discourage prompt realization of gains, and thus actually decrease the taxes collected.

15. An in depth analysis of the desirability of the double tax system is beyond the scope of this article. If the burden of the corporate tax is totally shifted from the shareholders to others, there is, in reality, no double taxation. If such a result occurs, then, the present system of "double taxation" becomes merely an efficient method by which the government collects taxes; it becomes a system the worth of which is difficult to challenge. *See* M. KRZYZANIAK & R. A. MUSGRAVE, THE SHIFTING OF THE CORPORATION INCOME TAX (1963); Goode, *Who Bears the Corporation Income Tax?* 32 U. CHI. L. REV. 410 (1969); Stiglitz, *The Corporation Tax,* 5 J. PUB. ECON. 303 (1976).

by examining its application to the treatment of corporate distributions to shareholders: A) in complete liquidation of the corporation, including discussion of problems created by the sale of stock and presentation of an alternative provision to replace present Code section 331(a)(1); B) in redemption with an analysis of bootstrap acquisitions; C) in partial liquidation; D) which except for the absence of earnings and profits would be treated as dividends; E) in complete liquidation under Code section 333; F) which are now governed by Code section 341; and G) which constitute boot received in connection with an otherwise tax-free reorganization. Third, this article examines the need for allocation of contributed capital among shareholders caused by different issue prices of stock within the same class, convertible stock, reorganizations, and sections 305 and 306. Moreover, different methods for effecting such allocations are discussed. Finally, potential tax avoidance difficulties which adoption of this proposal may create are considered and possible solutions explored.

I. THE FULLY QUALIFIED CORPORATION

The proposed test for determining whether a corporation is a Fully Qualified Corporation is based on the ratio of lifetime dividend payments of a corporation over the capital contributed by its shareholders. Payment of dividends as defined in section 316 results in the inclusion in the gross income of non-corporate shareholders the amount of such dividends.[16] A corporate distribution can only be a dividend, as opposed to a return of capital or gain in excess of return of capital, if the corporation has sufficient earnings and profits. Corporate earnings and profits bear a fixed relationship to the corporation's taxable income and to its earned surplus, and each item can be derived from the other.[17] The existence of earnings and profits normally will indicate that a corporation has earned profits which have been subjected to the corporate tax. Thus, the payment by a corporation of dividends is a cornerstone of the double tax system, and the amount of

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16. I.R.C. § 316(a) defines "dividend" as

any distribution of property made by a corporation to its shareholders —

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

I.R.C. § 301(c)(1) states that "that portion of the distribution which is a dividend (as defined in § 316) shall be included in gross income." I.R.C. § 301(b)(1)(A) states that the amount of a distribution to a non-corporate distributee is "the amount of money received, plus the fair market value of the other property received."

17. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 7.03 (3d ed. 1971).

dividends paid will constitute a handy tool for measuring the extent to which a corporation and its shareholders have submitted to the double taxation of corporate gain or have avoided it.[18]

What ratio of lifetime corporate dividend payments to the excess in value of such corporation's assets over the capital contributed by its shareholders (such excess in value being sometimes hereinafter referred to as "net asset value"), should make a corporation Fully Qualified (one whose shareholders are entitled to capital gains treatment on corporate distributions)? A satisfactory ratio should be one which is attainable by a continuing corporation upon its liquidation.[19]

While not conclusive, the ratio of dividend payments to net earnings under present law suggests that an average corporation could be expected to pay out fifty per cent of its net earnings in dividends.[20] Since present law favors the distribution of a corporation's assets to its shareholders as other than a dividend,[21] it seems probable that an even higher percentage of an average corporation's net earnings directly benefits its shareholders. Nevertheless, to illustrate this article's proposal, a one-to-one ratio of dividends to net asset value will be required of a Fully Qualifying Corporation.[22] Thus, a Fully Qualified Corpora-

18. The fact that a shareholder is not required to include in gross income his or her pro rata share of retained corporate earnings constitutes a substantial economic benefit to shareholders.

In Eisner v. Macomber, 252 U.S. 189 (1920), the Supreme Court rejected the contention that under the sixteenth amendment a shareholder should be taxed on his share of retained corporate earnings. To date, Congress has not attempted to institute such a system.

Appreciation in asset value goes untaxed at the corporate level until a taxable event occurs which is of assistance to corporations since it prevents capital needed in the business from being diverted to the payment of taxes on appreciation which has not been translated into money or its equivalent. Accordingly, the growth corporation which profits from the deferral of tax on asset appreciation, and whose shareholders profit from the deferral of taxation on undistributed earnings, should pay its dues while it continues to exist by paying out dividends if it wishes preferential treatment upon liquidation. Other corporations may not pay out dividends because no profits are made and no net appreciation in asset value occurs. Such corporations will be unconcerned with the need to earn preferential treatment for their liquidating distribution since they should not realize gain on liquidation. In between is the corporation which defers paying dividends for no corporate business purpose, but only to shield its shareholders from dividend treatment of its earned surplus. Such shareholders cannot complain that the earned capital gain concept for redemptions or liquidations is inequitable, since they are merely being charged for previous deferral.

19. *See* note 6 *supra*.

20. This ratio has fluctuated. According to one commentator, American industrial corporations normally have paid out between fifty to seventy per cent of net earnings as dividends. G. L. LEFFLER, THE STOCK MARKET at 26 (1963). The average dividend payout as a percentage of profit for all American companies for each of the years from 1956 through 1960 was respectively 52%, 56%, 65%, and from 1940 through 1954 averaged 45%. H. E. DOUGALL & H. G. GUTHMANN, CORPORATE FINANCIAL POLICY at 540 (1962).

21. *See* note 13 *supra*.

22. In the discussion which follows in Section II, the reader should keep in mind that a higher required ratio of dividends to net asset value would result in a greater lifetime tax burden to a lifetime shareholder of a liquidating corporation, and that a lower required ratio would result in a

tion shall refer to a corporation whose lifetime dividend payments equal its net asset value.

II. CORPORATE DISTRIBUTIONS

A. Complete Liquidation

The proposed treatment of corporate distributions in part or full payment in exchange for stock of its shareholders will be developed first by considering the treatment of distributions in complete liquidation of a corporation. Four types of corporations might be involved with a complete liquidation under the corporate dividend ratio to net asset value test. The corporation might be: (1) a Fully Qualified Corporation (lifetime dividend payments equal or exceed the corporation's net asset value), (2) a corporation which has not paid sufficient dividends to be Fully Qualified, but has enough earnings and profits to make up the deficit in dividend payments, (3) a corporation which is neither Fully Qualified nor possessed of sufficient earnings and profits to recoup the deficit in dividend payments but has paid or could pay some dividends, or (4) a corporation which is not Fully Qualified, has no earnings and profits and has paid no dividends.

The treatment of shareholders of each of these corporations (hereinafter referred to as category 1, 2, 3, or 4 Corporations respectively) can be understood best by considering a few concrete examples.

EXAMPLE 1: A contrast between Corporation A (category 1) and Corporation B (category 2) is instructive. Assume that both have been in existence and actively operated for twenty years. Since their respective incorporations, all of the outstanding stock of Corporations A and B has been owned by the original incorporator.

Corporation A was formed by its sole shareholder A-1 for an original capital contribution of $10,000. It has paid lifetime dividends in the amount of $100,000, and has a fair market value for its assets of $110,000. Thus, Corporation A has a net asset value (fair market value of $110,000 less contributed capital of $10,000) of $100,000. Since the lifetime dividends paid by Corporation A equal its net asset value, it is Fully Qualified. Corporation A adopts a plan of complete liquidation, sells its assets and then distributes to A-1 in exchange for his stock the sum of $110,000. Under present section 331, A-1 would be entitled to treat his gain of $100,000 as a capital gain.[23] Under the proposed treatment of liquidations, A-1 will also be entitled to treat his gain of $100,000 as a capital gain since Corporation A is a Fully Qualified Cor-

lower lifetime tax burden to a lifetime shareholder of a liquidating corporation. The effect of using any ratio is discussed in Section II *infra*.

23. *See* note 6 and note 13 *supra*.

poration.

Like Corporation A, Corporation B was formed by its sole shareholder B-1 for an original capital contribution of $10,000; unlike Corporation A, Corporation B has paid no dividends, though it has earnings and profits of $200,000. Corporation B has a fair market value for its assets of $210,000 and thus a net asset value of $200,000. Corporation B adopts a plan of complete liquidation, sells its assets and then distributes to B-1 in exchange for her stock the sum of $210,000. Under present section 331, B-1 would be entitled to treat her gain of $200,000 as a capital gain.

The disparity in the treatment of A-1 and B-1 is evident. Assume that A-1 and B-1 for all years in question would have been taxed on any income from Corporation A or Corporation B, respectively at the marginal rate of seventy per cent.[24] Corporation A had a lifetime net asset value of $200,000, half of which was distributed to A-1 as a dividend and half of which was the gain recognized by A-1 upon the liquidation of Corporation A. Under present law, A-1 paid taxes in the amount of $70,000 for the dividends received and $35,000 (capital gains treatment) for the liquidating distribution. Corporation B had a lifetime net asset value of $200,000, all of which was recognized by B-1 upon the liquidation of Corporation B. Under present law, B-1 paid taxes in the amount of $70,000 on the liquidating distribution. Though Corporation A and Corporation B had the same lifetime net asset value, A-1 has paid taxes in the amount of $105,000, while B-1 has paid taxes in the amount of $70,000. Thus, present law has enabled Corporation B to manipulate its affairs in a manner which greatly reduces the double tax burden for Corporation B and for its shareholder B-1; whereas, Corporation A has been penalized for its submission to the double tax system.

Under the proposed system, Corporation B is not a Fully Qualified Corporation, but has sufficient earnings and profits to pay a qualifying dividend. Thus, under the proposed system, Corporation B would have to pay out $100,000 in dividends thereby decreasing its net asset value to $100,000 in order to become a Fully Qualified Corporation. The gain of $100,000 on the subsequent liquidating distribution would then be entitled to capital gains treatment. Alternatively, B-1 could be required to treat $100,000 of the liquidating distribution as a dividend with the remainder of the distribution being entitled to capital gains treatment, and Corporation B would not be required to issue a formal

24. Seventy per cent is the top tax rate provided by I.R.C. § 1 and all examples in this article assume that the individual affected takes a given item into gross income at that marginal rate. For ease of illustration all computations in this article are made without taking into account the minimum tax provisions of I.R.C. §§ 56-58, the maximum tax provisions of I.R.C. § 1348, or the

dividend. It is debatable whether to require a corporation to pay out qualifying dividends or to treat automatically an appropriate portion of the liquidating distribution as a dividend up to the amount of the corporation's earnings and profits. Essentially, however, this question is secondary to a consideration of the main proposal. Therefore, it is hereinafter assumed that a corporation has paid out the maximum dividends which its earnings and profits would allow, up to the amount needed to become Fully Qualified.

EXAMPLE 2: Consider now Corporation D (category 4). Assume Corporation D has been in existence for one year and was formed by its sole shareholder D-1 for an original capital contribution of $10,000. Corporation D used the contributed capital to make a motion picture which upon its completion is determined to have a fair market value of $210,000, having a basis to the corporation of $10,000.[25] Assuming Coporation D is a collapsible corporation, if it adopts a plan of complete liquidation and distributes the motion picture to D-1 in exchange for her stock, then D-1 will be required to treat her gain of $200,000 as gain from the sale or exchange of property which is not a capital asset. Under the proposed treatment of complete liquidations, Corporation D is not a Fully Qualified Corporation since it has paid no dividends, and has no earnings and profits out of which to pay them. Accordingly, D-1 is not entitled to preferential treatment on her liquidating gain of $200,000 under the proposal. Corporation D would be able to become a Fully Qualified Corporation if it sold the motion picture before adopting a plan of complete liquidation since it would then have earnings and profits out of which to pay qualifying dividends. Of course, Corporation D would be subject to corporate tax on the gain realized on the sale of its sole asset.[26] Whether under the proposed treatment of liquidating distributions it would be preferable for a collapsible corporation to become a Fully Qualified Corporation or merely to distribute its assets after adoption of a plan of complete liquidation will depend on the rate at which the corporation's sale of its assets would be

twenty-five per cent tax ceiling of I.R.C. § 1201(b).

25. I.R.C. §1012 provides that the basis of property is its cost.

26. To illustrate this point, assume that Corporation D sells the movie with the $200,000 gain being taxed at the rate of 30%. Half of the after tax earnings of $140,000 are distributed to D-1 as a dividend which results in D-1 being a Fully Qualified Corporation because total dividends ($70,000) equal corporate net asset value (fair market value of remaining assets less contributed capital). The remaining $80,000 is distributed to D-1 in exchange for her stock, resulting in a $70,000 capital gain. Assuming D-1 is taxed at the rate of 70%, *see* note 24 *supra,* the taxes paid on such transactions are $60,000 in corporate tax, $49,000 tax to D-1 on the dividend received, and $24,500 tax to D-1 on her gain on the liquidating distribution. Total taxes paid by D and D-1 would thus be $133,500, a slight savings over the $140,000 in tax to D-1 which would result under the proposal if Corporation D had merely distributed the motion picture to D-1 in complete liquidation. Such result is not objectionable since it is a consequence of D and D-1 submitting cor-

taxed and the rate at which shareholders will be taxed on receipt of a dividend or liquidating distribution.

EXAMPLE 3: The final situation is that of a category 3 corporation. Assume Corporation C was formed by its sole shareholder C-1 for an original capital contribution of $10,000, and that C-1 has remained the only shareholder of the corporation during its ten year existence. Corporation C owns real property which has greatly appreciated in value. The corporation has operated a drive-in movie theater on the property with the expectation of selling such property for development when growth of the community made it profitable. Corporation C has paid lifetime dividends of $50,000, has no earnings and profits, and has a fair market value for its assets of $160,000. Thus, Corporation C has a net asset value of $150,000, and is not a Fully Qualifying Corporation because its dividends paid and payable (zero dividends are payable without earnings and profits) do not equal or exceed its net asset value.

Under present law, if Corporation C adopts a plan of complete liquidation, sells its assets, and then distributes to C-1 in exchange for his stock the sale proceeds of $160,000, C-1 will be entitled to treat his gain of $150,000 as a capital gain. Under the proposal, C-1 will not be entitled to treat his gain of $150,000 as a capital gain. Unlike Corporations A and B, Corporation C has not earned such preferential treatment for its shareholder C-1 because it has not submitted its appreciation in asset value to double taxation. However, unlike Corporation D, Corporation C has submitted to the double tax system to some extent as its dividend payments indicate, and it would be inequitable to deny C-1 credit for such dividend payments. Therefore, C-1 should be entitled to treat $50,000 of his liquidating gain as capital gain since such is the amount of Corporation C's dividend payments.[27] The remaining gain of $100,000 should be treated as gain from the sale or exchange of a non-capital asset. Thus, assuming C-1 will be taxed at a rate of seventy per cent, the proposed treatment would result in a tax to C-1 upon his liquidating gain of $87,500; whereas, present law would result in a tax of $52,500.

If the proposed treatment discussed in Examples 1, 2, and 3 were adopted, then the following picture of the resulting corporate-shareholder tax system would emerge. The continuing corporation which submits to the double tax system would be favored over the corporation which liquidates without permitting double taxation of corporate appreciation in value. To accomplish this favoritism of the con-

porate gain to the double tax burden.

27. If the ratio of dividends to net asset value required of a Fully Qualified Corporation was made less than one-to-one, then the credit for dividends paid would decrease. Likewise, if the ratio was made greater than one-to-one, the credit would increase.

tinuing corporation, a shareholder will be entitled to capital gains treatment of his or her gain on liquidation only to the extent of such shareholder's pro rata share of the lifetime dividends paid by the corporation, with any excess of such liquidating gain being considered as gain from the sale of a non-capital asset.

1. Problems Created by Sale of Stock

The key to the proposed system is the government's expectancy that liquidating gains will be treated as gain from the sale of a non-capital asset, or as ordinary income, to the extent such liquidating gains are unmatched by dividends paid by the corporation during its lifetime (or by such shareholder's pro rata share in the case of multiple shareholders).[28] Thus far, this article has considered the treatment upon liquidation of a shareholder who was the original incorporator of his or her corporation, and who has owned all of the shares since incorporation. In such original owner cases, the government anticipates that the corporation's lifetime appreciation in value will result in ordinary income treatment of liquidating gains to the extent not matched by dividends, with liquidating gains meaning the excess in value of liquidating distribution over the corporation's contributed capital or the original shareholder's basis for his or her shares.[29] In other words, the shareholder's basis in his or her stock and the capital contributed for such stock are identical. This is not so once the original owner has sold or otherwise disposed of his or her shares. Under existing law, originally contributed capital is the measure of gain upon liquidation only if the original shareholders have not sold their shares for an amount other than the original capital contributed for them.[30] In the present system of corporate shareholder-taxation, there is no relation between the cost basis for stock and the original capital contributed for that stock.[31]

It is important to recognize that a purchaser of stock does not invest

28. *See* discussion of FULLY QUALIFIED CORPORATION, Section I *supra*.

29. *Id.*

30. I.R.C. § 1001 provides that "the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis" of such property. I.R.C. § 1012 provides that, with certain exceptions, "the basis of property shall be the cost of such property." Thus, if a sale has occurred for an amount other than the original capital contributed for such share, the resulting cost basis will be used to measure gain upon liquidation. *See also* note 13 *supra* for discussion of the operation of I.R.C. § 331 which governs liquidations.

31. Hereinafter the original capital contribution attributable to a given share of stock shall sometimes be referred to as the "capital component" of such share, and the cost to a given purchaser of his shares shall be referred to as such shareholder's basis in such shares. Thus, if an original incorporator received one share of the stock of X Corporation for a contribution to its capital of $500 and later sold such share of stock to Y for $1,000, then such share of stock would have a capital component of $500 and a basis to Y of $1,000.

money directly in the issuer, but rather buys the investment represented by the stock purchased. A sale of shares by an original incorporator represents a realization by the selling shareholder of his or her portion of the increase in value of the corporation's underlying assets resulting from the retention or increase in value of property in excess of the original capital contributed for his or her shares. Though share price may reflect anticipated future earning power or items other than true asset value,[32] such difference presumably evaporates at the point of business cessation. Thus, sales of shares are but a stage in the ultimate liquidation of the enterprise which, in effect, enables the seller to liquidate his or her investment, under present law as capital gain, before the corporation is itself liquidated.

In considering the problem caused by the sale of stock, let us again refer to Corporation C which was formed by C-1 for an original capital contribution of $10,000. It has been in existence for ten years, has paid lifetime dividends of $50,000, has no earnings and profits, and has a fair market value of $160,000. Following the proposed scheme,[33] if Corporation C adopts a plan of complete liquidation, sells its assets and distributes the sale proceeds of $160,000 to C-1, then C-1 will treat $50,000 of his gain as capital gain and $100,000 as ordinary gain from the sale of a non-capital asset. Suppose C-1 sold all of his shares to C-2 for $100,000 five years after the incorporation of Corporation C. C-2 operates Corporation C for five years and then elects to adopt a plan of complete liquidation, sell the assets of Corporation C and distribute the sale proceeds of $160,000 in exchange for the stock of C-2. What is the amount of gain realized by C-1 on his sale of stock and C-2 on her liquidating distribution and how are such gains to be treated?

Assume that C-1 and C-2 will be taxed on all income at the rate of seventy per cent. If C-1 had retained the ownership of his stock and liquidated the corporation, then upon liquidation, his gain of $150,000 would have been treated as capital gain to the extent of the lifetime dividend payments of Corporation C ($50,000), yielding a tax of $17,500, and as ordinary gain for the portion of total gain unmatched by dividends ($100,000), yielding a tax of $70,000, for a total tax of $87,500. What is the result when C-1 has sold to C-2 for $100,000 as outlined in the immediately preceding paragraph? If we allow capital gains treatment of the sale of shares, then C-1 pays a tax of $31,500 on his capital gain from the sale of his stock. If we allow earned capital gains treatment to C-2, then C-2 has a liquidating gain of $60,000 which is capital gain to the extent of the $50,000 of dividends paid, yielding a

32. *See generally* G. D. McCARTHY & R. E. HEALY, VALUING A COMPANY (1971).

33. *See* discussion of FULLY QUALIFIED CORPORATION, Section I *supra*.

tax of $17,500, and is ordinary gain to the extent of $10,000, yielding a tax of $7,000. Thus, the total tax received by the government from C-1 upon liquidation in the first case is $87,500; while, in the second case the government would receive from C-1 and C-2 only $56,000 in tax. As a result, the government's expectancy that one-half of lifetime corporate appreciation will be paid out as dividends, and that to the extent of a short-fall in such dividend payments liquidating gains will be treated as ordinary gain,[34] will be defeated by a sale of shares unless a change is made in the proposal to account for such possibility.

There are two possible ways to modify the earned capital gains concept to handle the problem caused by the sale of shares. One is to test each sale of a share for its qualification for capital gains treatment. The other is to burden the holder of shares when liquidation occurs with an additional tax based on the tax revenue lost by the government as a result of the automatic capital gains treatment afforded the various sellers of shares.

The first possibility is that instead of allowing capital gains on all sales of shares with a reckoning for the consequences of insufficient dividend payment only upon liquidation, a seller of shares should be entitled to capital gains treatment only if and to the extent that the dividend payments of the issuer to the date of sale entitle him under the earned capital gains approach. Thus, if at the time of C-1's sale of his stock to C-2 for $100,000, Corporation C had paid $25,000 in dividends, then the gain of $90,000 recognized by C-1 would be treated as a capital gain to the extent of $25,000 and as ordinary gain to the extent of $65,000.

At least six objections can be made to treating sales of shares in this manner: (1) it would create a bias against earnings retention which might be inconsistent with the capital needs of the economy; (2) it would make it more difficult for growth companies to raise equity capital; (3) no corporate assets actually leave corporate solution on a sale of shares; (4) such treatment would discriminate against purchasers of stock who sell out at times of dividend deficiencies which are later eradicated; (5) many more sales occur than do liquidations and each of these sales would become a matter of complexity; (6) the corporation would be required to make complicated adjustments to its bookkeeping to keep track of the dividend account.

The second possibility is to allow capital gains treatment of all shares in a going enterprise with a reckoning for the consequences of insufficient dividend payment only upon liquidation. Under such an approach, the purchaser of shares in a non-Fully Qualified Corporation

34. *Id.*

would be thought of as having assumed the tax liabilities owed by the previous owners of such shares, if any, or as having purchased his or her shares subject to a contingent tax liability. Upon the sale of C-1's stock, the government allowed C-1 to treat his gain of $90,000 as a capital gain even though the corporation had not paid dividends in such amount. At liquidation, Corporation C has paid dividends of $50,000, which means that $40,000 of C-1's gain was treated as capital gain rather than the ordinary gain to which the government was entitled under the proposed scheme. To give the treasury the tax which it is due and to make the earned capital gains concept work, C-2 must recognize an imputed ordinary gain sufficient to produce the tax which has otherwise been lost because of (a) the capital gains treatment afforded C-1 on his sale of stock, and (b) the failure of Corporation C to pay dividends sufficient to become a Fully Qualified Corporation. C-1 paid a capital gains tax of $14,000 on the $40,000 of gain not ultimately matched by corporate dividend payments. This gain should have been taxed as ordinary income yielding $28,000 in tax. This tax may be recouped upon liquidation by requiring C-2 to pay a tax of $14,000, the actual amount of the contingent tax liability which she assumed or took subject to upon her purchase from C-1. Thus, C-2 upon liquidation will be required to report as an imputed ordinary gain the sum of $20,000. The dividends of Corporation C are exhausted by application against the gain of C-1, leaving no dividends to match against C-2's liquidating gain of $60,000 which is treated, therefore, as ordinary gain. The result is a tax to C-2 of $14,000 on the imputed ordinary gain (the contingent tax liability of C-1 which C-2 is deemed to have assumed or taken subject to) and a tax to C-2 of $42,000 on her liquidating gain. When C-2's total tax of $56,000 is added to the $31,500 in tax paid by C-1 for his gain upon the sale of his shares, the total tax recovered by the government from liquidating and quasi-liquidating (sales of shares) distributions is $87,500, the same amount of tax as the government would have recovered if C-1 had remained the owner of Corporation C until its liquidation.

Obviously, in any given corporation, the government will not receive the same amount of lifetime tax from shareholder gain when sales of stock occur as it would receive if there were no sales, unless the tax rates are identical for all shareholders at all times. Nonetheless, looking at all liquidations, the rates should average out so that the total receipts by the government should be roughly the same under the modified proposal whether sales of shares occur or not. Additionally, the proposed imputation of ordinary gain in an amount equal to one-half of the prior capital gains unmatched by dividends at liquidation is slightly unfair to corporate shareholders since they receive less than a fifty per cent capital gains preference. This, however, would constitute simply another factor in corporate share purchase decisions.

Each purchaser of shares will be interested in the dividend payments of a given corporation and the capital component of the shares which he or she contemplates buying. A purchaser would take his or her shares with a contingent imputed ordinary gain having a maximum amount equal to one-half of the amount by which the excess of the purchase price paid for his or her shares (the purchaser's basis) over the capital component of such shares exceeded the share of corporate dividend payments attributable to such shares. Thus, when C-2 purchased C-1's shares for $100,000, the purchase price exceeded the capital component of such shares by $90,000, and there was only $25,000 in dividend payments, giving C-2 a contingent imputed ordinary gain in the maximum amount (if no further corporate dividends were paid) of $75,000. It will be a simple matter for a non-Fully Qualified Corporation to make available for dissemination to potential market investors the capital component of its share and the dividends paid which are attributable to a share. This proposal leaves to each purchaser of shares the task of evaluating the risk of liquidation, the corporation's past dividend history and its future prospects. Presumably, the purchaser of shares will be willing to pay less to the extent of the risk of liquidation. Thus, the owner of shares in a non-Fully Qualified Corporation will be unable to enrich himself or herself unjustly. It seems more consistent with the purpose of the earned capital gains treatment proposal of favoring continuing corporations that sellers of shares be allowed capital gains treatment regardless of the corporation's dividend payment status at that time, with the accounting for dividend deficiencies postponed until liquidation. This allows a corporation to structure its dividend payouts as its business needs require and does not penalize shareholders who sell out at periods when an ultimately Fully Qualified Corporation is dividend deficient. Therefore, further references in this article to the treatment of liquidations will assume that such approach has been adopted, rather than the approach testing each sale of shares.

Thus far, the analysis has considered the application of the earned capital gains concept in the case of liquidations where: (1) the shareholder's basis for stock to be surrendered equalled the capital component of such shares and (2) the value of the liquidating distribution exceeds the shareholder's basis for stock to be surrendered and (3) the basis exceeds the capital component of such shares. There are two other possible situations. The first is where a shareholder's basis for his or her shares exceeds both value of the liquidating distribution and the capital component of such shares. The second is where the capital component of shares exceeds its basis.

EXAMPLE 1: Assume that C-2 purchased the stock owned by C-1 for $100,000, that Corporation C paid out lifetime dividends of $50,000, but unlike the earlier case, Corporation C upon its liquidation has a fair market value of $90,000. As in all previous examples, C-1 and C-2 are taxed at the rate of seventy per cent. If C-1 had retained the ownership of his shares, then, upon receipt of a liquidating distribution of $90,000, his gain of $80,000 would under the earned capital gains formula be treated as a $50,000 capital gain and a $30,000 ordinary gain, yielding a total tax of $38,500. To insure equivalent tax burdens regardless of the sale of shares, C-2 will be treated as follows: C-2 will receive a capital loss of $10,000, representing the difference between her basis and the value of the liquidating distribution, a potential tax benefit of $3,500; C-2 will recognize an imputed ordinary gain of $15,000, representing one-half of the excess of the difference between the value of the liquidating distribution and the capital component of surrendered shares, over the lifetime dividend payments of the corporation, a tax cost to C-2 of $10,500. Thus, the net tax cost to C-2 is $7,000 which when added to the total $31,500 of capital gains tax paid by C-1 on his gain of $90,000 from the sale of his shares results in a total tax yield to the government of $38,500, the same amount as would have resulted had C-1 remained the owner of his shares until the liquidation of Corporation C.

EXAMPLE 2: There may be cases where a shareholder will purchase shares for less than its capital component. Suppose C-2 purchased the shares of C-1 for $5,000 one year after the formation of Corporation C, at which time no dividends had been paid and Corporation C was worth only $5,000. C-1 obtained a capital loss on the sale of his stock, a potential tax benefit of $1,750.

If Corporation C were ultimately liquidated having a fair market value of $2,500, then C-2 would suffer a capital loss of $2,500, a potential tax benefit of $875. The total potential tax benefit derived from Corporation C would thus be the same whether or not C-1 had sold his shares. If instead, Corporation C is liquidated after the payment of $50,000 in lifetime dividends and at a time when its fair market value is $160,000, then the following treatment of C-2's gain of $155,000 will result: C-2 will receive a capital gain of $5,000 representing the difference between her basis and the capital component of her shares, yielding a tax of $1,750 (and off-setting the tax benefit afforded to C-1 on the capital loss resulting from the sale to C-2); C-2 will receive a capital gain of $50,000 (amount equal to dividend payments) yielding a tax of $17,500; the remaining gain will be treated as ordinary gain yielding a tax of $70,000. This brings the same total tax yield to the government as would have resulted had C-1 retained his shares rather than selling out to C-2.

2. Proposed Section in Lieu of Section 331(a)(1)

The preceding examples have demonstrated the application of the earned capital gains concept to liquidating distributions. Without at this point attempting to define further the concepts developed above, consider how such a provision might look upon its codification. The following proposed section would be substituted for present section 331(a)(1) of the Internal Revenue Code:

(1) COMPLETE LIQUIDATIONS —

(A) Upon the receipt of a distribution in complete liquidation of a corporation, the recipient shall recognize an imputed ordinary gain equal to one-half of the amount, if any, by which the lifetime dividend payments attributable to his shares surrendered in such complete liquidation are exceeded by the difference, but not less than zero, obtained by subtracting the capital component of such surrendered shares from the lesser of the shareholder's basis for such surrendered shares or the fair market value of the liquidating distributions.

(B) If amounts distributed in complete liquidation of a corporation are exceeded by the surrendering shareholder's basis for the stock for which such distributions are made, such deficit shall be treated as loss from the sale of a capital asset. If amounts distributed in complete liquidation of a corporation are in excess of the surrendering shareholder's basis for the stock for which such distributions are made, and if the capital component of the surrendered shares exceeds the shareholder's basis for such shares, then such portion of the excess of the value of the liquidating distribution over the shareholder's basis as does not exceed the excess of the capital component of the surrendered shares over the shareholder's basis for such shares shall be treated as gain from the sale of a capital asset. If amounts distributed in complete liquidation of a corporation are in excess of the surrendering shareholder's basis for the stock for which such distributions are made, then the excess of the value of the liquidating distribution over the greater of the capital component of such shares or the shareholder's basis therefor shall be treated as gain from the sale of a capital asset to the extent such excess does not exceed the difference obtained by subtracting from the lifetime corporate dividend payments attributable to such share, the amount, if any, by which the basis of the surrendered shares exceeds the capital component thereof. If after application of the immediately preceding two sentences, there remains untreated as capital gain any portion of the excess of the amounts distributed in complete liquidation of a corporation over the shareholder's basis for the shares surrendered, then such remaining gain shall be treated as gain from the sale of a non-capital asset.

3. Effect of Proposal on Tax Burdens

As a final point, it might be helpful to consider the tax burden resulting in various situations under the proposal by examining the following tables. The Tables deal with a corporation which is an amalgamation of the various corporations which we have examined in this section. The corporation involved was formed by its original incorporator A-1 for a capital contribution of $10,000. Table I shows the tax consequences to A-1 upon liquidation under various corporate dividend histories, which dividend payments are presumed to exhaust the earnings and profits of the corporation. Table II shows the treatment of A-2 upon liquidation, where A-2 has purchased all of A-1's shares for $60,000. Notice that under the proposed treatment the total lifetime tax burden (tax on dividends, gains on sales of shares and liquidation) is greatest when the corporation has paid no dividends and decreases as dividends are paid. In contrast, under present law, the total lifetime tax burden is least when no dividends have been paid, and increases as dividends are paid. Thus, the proposal rewards submittal to the double tax system where present law penalizes such action. Note that columns one and three of Table I should be read as part of Table II as well.

TABLE I

1	2	3	4	5	6	7
F.M.V. of Liquidating Distribution	Lifetime Dividends Paid or Payable	Tax on Dividends (@ 70%)	Tax to A-1 on Liquid. Gain Under Proposal	Tax to A-1 on Liquid. Gain Under Present Law	Total Tax Burden Under Proposal	Total Tax Burden Under Present Law
110,000	100,000	70,000	35,000	35,000	105,000	105,000
120,000	90,000	63,000	45,000	38,500	108,000	101,500
130,000	80,000	56,000	56,000	42,000	112,000	98,000
140,000	70,000	49,000	66,500	45,500	115,500	94,500
150,000	60,000	42,000	77,000	49,000	119,000	91,000
160,000	50,000	35,000	87,000	52,500	122,500	87,500
170,000	40,000	28,000	98,000	56,000	126,000	84,000
180,000	30,000	21,000	108,500	59,500	129,500	80,500
190,000	20,000	14,000	119,000	63,000	133,000	77,000
200,000	10,000	7,000	129,500	66,500	136,500	73,500
210,000	—0—	—0—	140,000	70,000	140,000	70,000
					(3 + 4)	

TABLE II

8	9	10	11	12	13
Tax to A-1 on Sale of Shares to A-2	Tax to A-2 on Imputed Ordinary Gain Under Proposal	Tax to A-2 on Liquidating Gain Under Proposal	Tax to A-2 Upon Liquid. Under Present Law	Total Tax Burden Under Proposal	Total Tax Burden Under Present Law
17,500	—0—	17,500	17,500	105,000	105,000
17,500	—0—	28,000	21,000	108,500	101,500
17,500	—0—	38,500	24,500	112,000	98,000
17,500	—0—	49,000	28,000	115,500	94,500
17,500	—0—	59,500	31,500	119,000	91,000
17,500	—0—	70,000	35,000	122,500	87,500
17,500	3,500	77,000	38,500	126,000	84,000
17,500	7,000	84,000	42,000	129,500	80,500
17,500	10,500	91,000	45,500	133,000	77,000
17,500	14,000	98,000	49,000	136,500	73,500
17,500	17,500	105,000	52,500	140,000	70,000
				(3 + 8 + 9 + 10)	(3 + 8 + 11)

B. Corporate Distributions in Redemption

The model for treatment of complete liquidations suggests that gain on redemptions[35] should be entitled to capital gains treatment only to a limited extent. It should be entitled to such treatment when the corporation's dividend history would result in capital gains treatment if a complete liquidation were carried out on the date of such redemption, with the excess gain being treated as ordinary income.

As long as sales of shares to third parties are entitled to capital gains treatment, how does one justify denying such treatment to a shareholder who has part or all of his or her shares purchased by the issuing corporation? As discussed earlier,[36] treatment of the gain (purchase price minus basis) realized by a seller of shares as automatically entitled to capital gain treatment is preferable to requiring that the gain from such sale be entitled to capital gains tax treatment only to the extent that the corporation's dividend history would qualify distributions in complete liquidation occurring on the same date. However, a redemption is much more akin to the final reckoning which takes place upon complete liquidation than it is to a sale of shares to outsiders.[37]

35. I.R.C. § 317(b) defines a redemption as follows: "stock shall be treated as redeemed by a corporation if the corporation acquires its stock from a shareholder in exchange for property, whether or not the stock so acquired is cancelled, retired or held as treasury stock."

36. *See* discussion in Section II(A)(1) *supra.*

37. In a redemption, corporate assets leave corporate solution while in a sale of shares they do not. In a sale of shares, each purchaser is accountable to the government for any existing or future deficiencies in the corporation's dividend account, while in a redemption, no one will ever

It has been argued that denying capital gains treatment to sellers of shares in non-Fully Qualifying Corporations would be both a deterrent to the ability of growth companies to raise equity capital and an unhealthy inducement to management to pay out as dividends earnings needed in the business.[38] Neither of these concerns would be present in the case of redemption which represents an attempt by management to reduce capital. The use of the earned capital gains treatment concept will create no information dispersal or administrative difficulty in the case of a Fully Qualified Corporation[39] since it will be unnecessary to inform a prospective redeemed shareholder of the status of the corporation's dividend account. Redemptions by less than Fully Qualified Corporations would have to be preceded by transmitting to persons whose shares the corporation wishes to redeem, information concerning the income tax consequences of tendering such shares for redemption.[40] Because redemptions by Non-Fully Qualified Corporations would result in a greater tax to the seller of shares than would result from sales to outsiders, Non-Fully Qualified Corporations wishing to redeem shares probably would have to pay a premium over the market value of their shares to induce shareholders to tender shares for redemption. This loss of opportunity to redeem shares freely in the market would not seem an unfair burden to place on such non-Fully Qualified Corporations.

To the extent that a corporation does redeem shares, an appropriate reduction in the corporation's dividend account would be required to prevent unwarranted benefit by the remaining shareholders from such redemption. Without a reduction, a corporation could become Fully Qualified by a series of redemptions instead of making dividend payments as contemplated by the earned capital gains concept. Accordingly, each redemption should result in the dividend account of the redeeming corporation being reduced by the product obtained by multiplying the amount of the dividend account prior to the redemption

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be called upon to account to the government for the tax lost on such distribution if the corpo ation is eventually liquidated with an insufficient dividend account.

38. *See* discussion of methods to modify earned capital gains concepts, Section II(A)(1) *supra*.

39. In this context, a Fully Qualified Corportion is one which has paid out dividends which on the date of the redemption equal the fair market value of the corporation minus the total capital component of its outstanding shares.

40. A legislative by-product of instituting the proposed changes would almost certainly be a requirement that publicly-traded companies provide information to a prospective redeemed shareholder if a redemption would subject a redeemed shareholder to a greater tax burden than would result from a sale of such shares to other than the corporation. Since a redemption by a Fully Qualified Corporation would not bring a greater tax, no disclosure would be necessary. However, a redemption by a less than Fully Qualified Corporation would result in a greater tax, and advance disclosure of this fact would be necessary.

by a fraction, the numerator of which is the number of shares redeemed and the denominator of which is the number of shares outstanding prior to the redemption. This formula will also prevent a corporation with excess dividends paid from increasing the disproportion of such excess to its fair market value as a result of a redemption.

The earned capital gains concept would work in the same manner for redemptions as for complete liquidations.[41] Thus, it might be helpful to review the various cases of complete liquidation examined earlier.[42] The treatment of a redeemed shareholder under the earned capital gains concept would be identical to that which resulted in those examples. As a result, the statutory revision which would be required to implement the proposal would be identical to that for a complete liquidation except for: (a) reference to redemption instead of liquidation, and (b) retention of the standards by which dividend equivalence are measured.

1. Bootstrap Acquisitions

The earned capital gains treatment of redemptions would be useful in the type of bootstrap purchase situation typified by *Zenz v. Quinlivan*[43] where continuing corporations are now disfavored. In *Zenz,* a corporation, the stock of which was wholly owned by one individual, had substantial accumulated earnings and profits which were unneeded in the business. In order that neither the buyer nor seller of the corporation's stock would be required to recognize these accumulated earnings and profits as a dividend taxable as ordinary income, the sale transaction was structured so that the buyer bought part of the seller's stock for cash, and then a short time later, the corporation redeemed the seller's remaining shares using up in the process most of the accumulated earnings and profits. The seller treated the gain on such redemption as capital gain.[44] The Internal Revenue Service argued that

41. Suppose Corporation E was formed in 1963 by two non-related individuals E-1 and E-2, each receiving 50 shares of common stock for a capital contribution of $5,000 each. In 1967, E-2 sold his shares to E-3 for $50,000. In 1977, Corporation E then having paid out dividends in the amount of $50,000, redeems E-3's shares for $80,000. E-3's pro rata share of lifetime corporate dividend payments is $25,000. As with complete liquidations, E-3 purchased her shares subject to a contingent imputed ordinary gain. Since E-2 received a capital gain on the sale to E-3 of $45,000, and since E-3's share of lifetime dividends is only $25,000, E-3 is charged with an imputed ordinary gain in the amount of $10,000 (one-half of the amount by which the difference obtained by subtracting the capital component of the redeemed shares from the lesser of such share's basis or the value of the liquidating distribution, exceeds such share's pro rata share of lifetime corporate dividend payments). E-3's gain on the redemption of $30,000 is treated as ordinary gain since not matched by corporate dividend payments. As a result of such redemption, the dividend account of Corporation E is reduced to $25,000.

42. *See* discussion of *Complete Liquidation,* Section II(A) *supra.*

43. 213 F.2d 914 (6th Cir. 1954).

44. *Id.* at 916.

the proceeds of the redemption should be treated as a dividend since if the prearranged redemption had preceded the sale of part of the shares such would have been the result. The Sixth Circuit Court of Appeals held in favor of the taxpayer.[45] The I.R.S. has announced that such a transaction will be treated as meeting the requirements of Code section 302(b)(3).[46]

To appreciate how this article's proposal would affect the bootstrap purchase situation, consider the following example. Assume that A is the sole shareholder of corporation XYZ. A has a $10,000 basis and capital component for her shares. XYZ has a book value of $400,000 allocated as follows: operating assets $100,000, and cash $300,000 ($50,000 needed in the business). XYZ has earnings and profits of $300,000. B has $250,000 to invest, and is willing to buy XYZ's operating assets for $200,000 or to have A take down a $250,000 dividend, and then sell her shares to B for $250,000. Instead, to come within the *Zenz* sale followed by redemption formula, B buys fifty per cent of A's shares for $250,000, and the corporation then redeems A's remaining shares for $250,000. Under existing law, this transaction would result in capital gains treatment for A's gain of $490,000. Under the proposed treatment of redemptions, A still would obtain capital gains treatment on her sale of shares; the redemption would be taxed to A as a gain, the character of which under the earned capital gains concept would be subject to the corporation's dividend history. If XYZ has paid no dividends, then A will incur ordinary income treatment on the redemption gain of $245,000, a result similar to the dividend treatment which would have occurred if a $250,000 dividend had preceded the purchase by B of the shares of A.

Under the proposed earned capital gains treatment of redemptions, the purchaser will not be disinterested in the form of the purchase transaction. Since a purchaser of shares takes them subject to a contingent imputed ordinary gain, the capital component of such shares and the

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45. The court stated "[w]e are satisfied that where the taxpayer effects a redemption which completely extinguishes the taxpayer's interest in the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend to him." *Id.* at 917-18.

46. *See* Rev. Rul. 55-745, 1955-2 C.B. 223. The relevant parts of I.R.C. § 302 reads as follows:

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

(b). REDEMPTIONS TREATED AS EXCHANGES. —

(3). TERMINATION OF SHAREHOLDER'S INTEREST — Subsection (a) shall apply if the redemption is in complete redemption of all the stock of the corporation owned by the shareholder.

dividend account of the issuer will be of substantial importance. Assuming that XYZ has a zero dividend account, if B goes along with the purchase-redemption scheme, B will own all of the outstanding shares of XYZ having a capital component of $5,000 and XYZ will have a zero dividend account; the redemption of A's remaining shares providing no addition to XYZ's dividend account since the payments to A were not a dividend. B would thus take his stock subject to a contingent imputed ordinary gain in the maximum amount of $245,000. The proposed treatment of redemptions thus puts A and B in the same position as if A and B had been the original incorporators of XYZ, contributing for their shares $5,000 each. Unless XYZ has a $250,000 dividend account, B will not be willing to pay $250,000 for the shares of A in either the bootstrap purchase or retiring original incorporator situation, nor will B be willing to have XYZ redeem A's shares for $250,000. The price B would be willing to pay or to have XYZ pay in redemption would be subject to negotiation. However, assuming similar tax situations for A and B, it seems clear that B would require XYZ to have a dividend account which makes it a Fully Qualified Corporation before B would be willing to buy A's shares for $250,000.[47] Thus, the proposed earned capital gains treatment of redemptions should eliminate the situations where a so-called bootstrap purchase has been thought to constitute an unwarranted conversion of ordinary income into capital gains.

C. Partial Liquidations

Partial liquidations would be handled in the same way as the proposed treatment of complete liquidations or redemptions. A

47. The following table illustrates the transaction structure which likely would occur under the proposed redemption treatment in three cases where B is the purchaser:

	XYZ's Dividend Account Prior To Transaction		
	$100,000	$490,000	$ 0
Fair Market Value of XYZ's Assets Before Transaction	500,000	500,000	500,000
Dividend To A	197,000	0	245,000
Redemption of A's Shares As Capital Gain	50,000	250,000	0
Purchase Price For Remainder of A's Shares	255,000	250,000	255,000
Capital Component of B's Shares	8,000	5,000	10,000
Dividend Account and B's Basis Minus Capital Component After Transaction	247,000	245,000	255,000

downward adjustment in the corporate dividend account would be made in an amount equal to the dividends used to determine the character of gain. It would be possible to limit the dividends which could be used to qualify a gain for capital gains treatment or to avoid the imputation of ordinary gain, to an amount bearing the same relationship to the lifetime dividend payments as the fair market value of the liquidating distribution bears to the pre-distribution fair market value of the corporation. This would be in keeping with the proposed treatment of redemptions which allows a redeemed shareholder to use only his or her pro rata share of lifetime dividend payments.

D. Distributions with Respect to Stock

The model developed has dealt with distributions by a corporation in exchange for its own stock. The model assumes that, to the extent of a corporation's earnings and profits, a dividend or an essentially equivalent distribution shall be included in a recipient's gross income.[48] The earned capital gains concept would be applicable to the determination of the extent to which a distribution which exceeds both earnings and profits and the basis of the stock on which it is made would be treated as a capital gain. In addition, shareholders other than the original owner of stock who receive such a distribution will in some cases be required to recognize an imputed ordinary gain. Unlike redemptions and complete liquidations, a shareholder receiving a distribution with respect to his or her shares does not surrender them, which under the proposed treatment will require an adjustment to capital component as well as to basis.[49] As with complete liquidations,

48. This accords with the present I.R.C. § 301(c)(1) which reads in relevant part: "That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income."

49. The modification required by the earned capital gains treatment can best be illustrated by example.

> Assume Corporation F was formed in 1964 by F-1 for an original capital contribution of $10,000. In 1970, F-1 sells his shares to F-2 for $100,000. F-1 and F-2 will be assumed subject to a seventy per cent rate of taxation at all times. In 1974, the corporation has a fair market value of $160,000, has paid out lifetime dividends in the amount of $50,000, but has no earnings and profits. If Corporation F distributes $10,000 to F-2 such distribution would constitute a return of capital reducing F-2's basis for her stock to $90,000, reducing the fair market value of Corporation F to $150,000, and also reducing the capital component of F-2's stock to zero. That such distribution would result in no recognition of imputed ordinary gain under the earned capital gains approach is seen by considering the liquidation of Corporation F. If immediately after such distribution Corporation F adopts a plan of complete liquidation, sells its assets and distributes $150,000 to F-2 for her stock, then F-2 will recognize an imputed ordinary gain of $20,000 (one-half of the excess of basis minus capital component over lifetime dividends), yielding a tax of $14,000. F-2 will recognize a liquidating gain of $60,000 which will be ordinary in nature because not matched by dividends, yielding a tax of $42,000. Thus the taxes on F-2 of $56,000 and the tax to F-1 of $31,500 on the sale of his shares to F-2, total $87,500. This is the same total tax which would have resulted had F-1 retained the ownership of his shares until

however, if the stock's capital component is greater than a shareholder's basis for such stock, then, any distribution in excess of basis but not in excess of capital component should be treated as a capital gain regardless of the status of the corporation's dividend account.[50]

Thus, distributions or portions of them which but for the absence of earnings and profits would be treated as dividends will be tested for earned capital gains treatment in the same manner as redemptions and complete liquidations. Any excess in value of a distribution over earnings and profits will reduce basis and at the same time reduce first capital component and then the dividend account. The excess of any distribution over a shareholder's basis will be capital gain to the extent matched by dividends, and ordinary gain to the extent unmatched by dividends. The excess of any distribution over both capital component and dividends paid will result in an imputed ordinary gain unless basis has been, or is simultaneously, exhausted. Distributions which represent the recovery of the excess of capital component over basis will constitute capital gain irrespective of the status of the corporation's divi-

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liquidation.

If Corporation F makes a second distribution of $10,000 to F-2 shortly after the first distribution, then the fair market value of the corporation will be reduced to $140,000 and the basis of F-2's stock will be reduced by $10,000 to $80,000. Since the capital component of F-2's shares is already zero, a reduction of $10,000 in the dividend account of Corporation F should be made. Again we can test the appropriateness of this treatment by looking at the tax consequences of the liquidation of Corporation F immediately after such second distribution. F-2 will recognize an imputed ordinary gain of $20,000 (one-half of basis minus capital component over dividend account, or one-half of, $80,000 minus zero, minus $40,000), yielding a tax of $14,000. F-2 will also recognize an ordinary gain on liquidation of $60,000 yielding $42,000 in tax. Again, the tax consequences of a liquidation would be the same as if F-1 had retained the ownership of his shares until liquidation.

If immediately after the second distribution, Corporation F makes a third distribution to F-2 in the amount of $50,000, then the fair market value of the corporation will be reduced to $90,000 and the basis of F-2's stock will be reduced to $30,000. Capital component has already been reduced to zero. Forty thousand dollars of the distribution will be applied to dividend account reducing it to zero. The $10,000 by which the distribution exceeds both capital component and dividend account will therefore trigger an imputed ordinary gain in an amount equal to one-half of the difference obtained by subtracting capital component from the lesser of such excess or the basis of the shares on which the distribution is made. Accordingly, F-2 will recognize an imputed ordinary gain of $5,000, yielding a tax of $3,500. If Corporation F liquidates immediately after such third distribution then F-2 will recognize an imputed ordinary gain in the amount of $15,000 (one-half of excess of basis minus capital component over dividend account), yielding $10,500 in tax. F-2 will again recognize an ordinary gain of $60,000 on the liquidating distribution ($90,000 minus $30,000, unmatched by dividends). Thus the requirement that F-2 recognize imputed ordinary gain after the exhaustion of capital component and dividend account operates to preserve the integrity of the proposed earned capital gains treatment.

50. To illustrate this point, assume that Corporation G is formed by G-1 for a capital contribution of $10,000. G-1 sells his shares to G-2 for $5,000. If Corporation G distributes $10,000 to G-2 at a time when the corporation has a fair market value of $20,000 and a zero dividend account, then capital component is reduced to zero and G-2's gain of $5,000 is treated as capital gain despite the absence of matching dividends.

dend account.

E. Distributions under Section 333

Section 333 of the Code allows a corporation to distribute all of its property in complete liquidation with gain recognized only to the extent of the corporation's earnings and profits and with the distributed assets taking a basis in the hands of the distributee shareholders equal to their basis in the stock surrendered less money received and plus gain recognized. However, section 333 may not be used by a collapsible corporation other than one meeting the requirements of section 341(e).[51] This exclusion indicates a lack of Congressional sentiment for the formation of corporations with the intention to liquidate them shortly thereafter. Bittker states that section 333 was "enacted in 1938 primarily to permit the liquidation of personal holding companies that had been recently subjected to unexpectedly heavy tax burdens"[52] and was intended to be only a temporary provision. Thus, section 333 may be viewed as an anachronism which has outlived its purpose, and therefore, should be repealed. Moreover, its present form is certainly at odds with the concept of earned capital gains treatment developed to this point.

This article does not advocate section 333's retention. If, however, Congress periodically adds relief provisions to the Code or if it elects to allow shareholders to withdraw their assets from the corporation with a deferral of gain, such provisions must be consistent with the earned capital gains concept. For instance, it would be possible to modify section 333 so that if a corporation could be completely liquidated under section 331(a) at full capital gains treatment because of its dividend history, shareholders could elect to receive and retain the corporation's assets, postponing until later their recognition of capital gain.[53]

51. As stated in B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, § 12.07 at 12-23:

> It is perilous to summarize the fearfully intricate conditions of § 341(e), but its underlying theory is that the collapsible corporation provisions should not be applicable if the net unrealized appreciation in the corporation's 'subsection (e) assets' (roughly speaking, property held by the corporation which would produce ordinary income if sold by the corporation itself or by its principal shareholders) amounts to less than 15 per cent of the corporation's net worth.

52. *Id.* at § 11.20 n.29.

53. For example, assume Corporation XYZ was formed in 1964 to construct and operate a shopping center. The original incorporator A had a capital component for her shares of $50,000. B purchased A's shares in 1970 for $450,000. The shopping center is XYZ's sole asset and has a net fair market value of $750,000. XYZ has no money or earnings and profits. XYZ has paid out $70,000 in dividends each year from 1966-75 for a total dividend account of $700,000, which equals the corporate net asset value ($750,000 fair market value of assets minus $50,000 capital component). Thus XYZ is a Fully Qualified Corporation and B would qualify for full capital gains treatment on a liquidating distribution, resulting in a capital gain of $30,000. A revision of I.R.C. § 333 which allowed B to receive the shopping center in liquidation without recognition of

F. Section 341

The proposed treatment of distributions in complete or partial liquidation, in redemption, and of distributions which would be dividends but for the absence of earnings and profits, and the suggested deletion of section 333, provide an objective test for determining when and to what extent preferential tax treatment is to be extended to corporate distributions. The test would apply to all corporations regardless of the subjective inquiry which the present section 341 employs,[54] and would turn on actual use of the corporate form. This article does not purport to analyze the complexities of section 341, but suggests that adoption of the earned capital gains concept would make its elimination possible.[55]

G. Boot in Reorganizations and Corporate Divisions

Boot received in connection with a tax-free reorganization or corporate division is treated presently under Code sections 356(a) and 356(b).[56] It is beyond this article's scope to evaluate the merits of this treatment under the present corporate taxation scheme. It is relevant, however, to illustrate how the treatment of boot in such sections could be made consistent with the proposed treatment for other corporate distributions.

Section 356(a) deals with the taxation of gains to a shareholder upon receipt of money or property ("boot") not entitled to be received without recognition of gain under section 354(a). Gain is measured by subtracting the transferor shareholder's basis in the shares which he or she surrenders from the fair market value of the property received in exchange, and then taxing, as either capital gain or ordinary income, the amount of the shareholder's gain, but not in excess of the boot

gain and with a basis to B of $450,000 would not be inconsistent with the earned capital gains concept.

54. Collapsible corporation status turns on whether a corporation is formed or availed of with the requisite "view." The determination of whether the requisite "view" existed and when such "view" existed are inherently subjective issues. The relevant portion of I.R.C. § 341(b)(1) is set out in note 8 *supra*.

55. Consider the classic motion picture collapsible corporation. If a corporation, formed with an original capital contribution of $10,000, produced a movie having a fair market value of $1,000,000, and before receiving any earnings distributed the movie in complete liquidation, then, the earned capital gains treatment of complete liquidation would result in $990,000 of ordinary income to the shareholders because of the lack of dividends. If the shares of the corporation were sold for more than the capital component, then, to the extent of such excess the purchaser would be subject to a contingent imputed ordinary gain. If the movie were distributed as a dividend, then, the proposed revision to I.R.C. § 301(c), *see*, Section II(D) *supra*, would result in ordinary gain treatment for the distributor since the excess of distribution over basis would be unmatched by dividend payments.

56. The term "boot" refers to property received in an exchange which is not entitled to be received without the recognition of gain. I.R.C. §§ 354 and 355 set forth the conditions under which stock and securities may be received without the recognition of gain. I.R.C. §§ 356(a) and

received. The following example demonstrates how section 356(a) works.[57]

In an exchange to which section 354 would apply but for the prohibited boot involved, A receives in exchange for a share of stock having an adjusted basis to A of $85:

One share of stock worth	$100
Cash	25
Other property (basis $25) fair market value	50
Total fair market value of consideration received	$175
Adjusted basis of stock surrendered in exchange	85
Total Gain	$ 90
Gain to be recognized, limited to cash and other property to be received	$ 75
A's pro rata share of earnings and profits (taxable dividend)	$ 30
Remainder to be treated as gain from the exchange of property	$ 45

Under the proposed treatment of exchange transactions, gain in excess of A's ratable share of earnings and profits will be entitled to capital gains treatment only to the extent qualified by the dividend account of the issuer of A's shares. Assume that the issuer of A's share prior to the exchange had a dividend account of $10,000 and that A's pro rata share of this account was $20. Application of the earned capital gains concept to the $45 excess of boot over dividend will result in A recognizing a $20 capital gain and a $25 ordinary gain, rather than the $45 capital gain which would result under present section 356(a).

Current section 356(b) treats boot as a distribution of property subject to section 301. Earlier, this article outlined a suggested amendment of section 301.[58] Thus, for purposes of the proposal, the reference in section 356(b) would refer to the amended section 301.

III. ALLOCATION OF CONTRIBUTED CAPITAL AMONG SHAREHOLDERS

To this point, the article has assumed a corporation simple in its capital structure. Now, attention is directed to the problems of complexity. Initial focus will be on corporations coming into existence after the enactment of the proposed legislation. Implementation of the

356(b) govern the treatment of "boot."

57. This illustration is taken from Treas. Reg. § 1.356-1(c), *Example 1.*

58. *See* discussion of amendment of I.R.C. § 301, in Section II(D) *supra.*

earned capital gains systems which looks to originally contributed capital in measuring imputed gains upon exchange transactions (whether in partial or complete liquidation or in redemption) requires a method of allocating contributed capital among shareholders so as to avoid hindering the stock market's functioning.

To illustrate the problem, this section will first consider the allocation made necessary by different issues of the same class of stock being made at different issue prices. In connection with this, the two best methods for effectuating such allocation — the "immediate averaging of capital component method" and the "sliding capital component method" — will be set forth. This section will then examine the problems of allocation which may arise in connection with convertible securities, reorganizations, stock outstanding on the effective date of legislation incorporating the article's proposal, and sections 305 and 306. For purposes of discussing the allocation of contributed capital, the amount of money or fair market value of property originally contributed for a stock or security shall continue to be termed the "capital component" of such share.

A. *Capital Component and Different Issues of Stock*

The necessity of allocating the capital component will often arise because of the possibility of many different issues of the same class of stock being made at different issue prices. If these issue prices are to have importance upon the complete liquidation of the corporation, and for other transactions, then either a separate market must be developed for trading in each issue of stock or a method of allocating capital among shareholders of different issues of the same class of stock must be developed.

Consider a publicly held corporation with one outstanding class of common stock issued for, and having a capital component of, $100 per share. No need for allocation is present as each purchaser of a share will take such share with its capital component of $100. In almost every case, however, a company going public will have existing shares outstanding of the class of stock being offered to the public, which existing shares will normally have a capital component different than the price at which the public offering is being made. Indeed, a portion of the public offering is often composed of the shares previously outstanding which are owned by the original investors. Hypothesizing that there are existing and outstanding 1000 shares of the common stock of Corporation A with a capital component of $50 per share, and that a public offering is made of 2000 shares of common stock (including 500 of the originally outstanding shares) at $100 per share, then, the problem of different issue prices becomes clear. What is to be the capital component of a share purchased from the previously outstanding category? If we are to avoid the necessity of creating separate markets for different issues of stock, and in this case separate markets even within the same issue, then, it is necessary to avoid treating each share sold as having a capital component of $50 per share if it happens to have been owned by an original incorporator, and $100 per share if it happens to be a newly issued share.

1. Immediate Averaging of Capital Component

There are two ways of treating the capital component of the shares involved in this transaction. The first would require that each of the purchasers of shares in the public offering be viewed as buying newly issued shares and previously outstanding shares in the same proportion as the total of such newly issued shares in the public offering bears to the total of such previously outstanding shares in the offering, with the capital component of such shares then being the average capital component of the shares included in the public offering. Thus, a purchaser of all 2000 shares in the public offering would take such shares with a capital component of $87.50 per share (1500 shares at $100 per share and 500 shares at $50 per share). A purchaser of any lesser number of shares would also take such lesser number of shares with a capital component of $87.50 per share.

A problem remains in connection with the 500 shares having a capital component of $50 which were not involved in the public offering. At some point, these shares may also be offered in the public market again creating the need for either a separate market or a further method of allocating the capital component. The second possibility, then, for treatment of the public offering is to include the capital component of all previously outstanding shares in the capital component computation made as a result of the public issue whether any or all of such previously outstanding shares are included in the public offering. In the example above, this would result in a capital component of $80 per share.

As theoretical justification for averaging the capital component of all outstanding shares of a class, whether included in the public offering or not, one could look at the public offering as having occurred as follows. The holders of the existing 1000 stock shares purchase from the corporation 1.5 newly issued shares at $100 per share for each share which they presently hold. This gives each pre-offering shareholder shares with an average capital component of $80 per share. The holders, then, elect to retain 500 of their shares with a capital component of $80 and to sell in the public offering 2,000 of their shares, having the same capital component. The sellers of the 1500 shares purchased for $100 would have no gain upon its resale for $100 in the public market.[59] Thus, the public offering could have been arranged as a secondary offering by the original shareholders with the same financial results to both the corporation and the holders of stock outstanding prior to the issue as would occur in a public offering made directly by the corporation. Since the transaction could have been arranged as a secondary offering by the original shareholders, there should be no objections to treating the transaction as if it had, in fact, so occurred for purposes of determination of the capital component of outstanding shares, unless there are possibilities of unfairness from such treatment.[60]

2. Sliding Scale Capital Component Approach

Nonetheless, some may be unpersuaded by such characterization of the public offering, feeling that the original shareholders are in fact getting something — a step-up in capital component — for nothing. These people would insist on looking at the "actual" contribution of capital. With such concern in mind, if the corporation is not a Fully Qualified Corporation and is liquidated while any of such pre-offering shareholders who has received the increase in capital component is still a shareholder, or if any of such pre-offering shareholders have their shares redeemed in a transaction not essentially equivalent to a dividend at a time when the corporation is not a Fully Qualified Corporation, then such shareholder will be viewed as recognizing either less imputed

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59. Treas. Reg. § 1.1012-1(c) provides in relevant part as follows:

> If shares of stock in a corporation are sold or transferred by a taxpayer who purchased or acquired lots of stock on different dates or at different prices, and the lot from which the stock was sold or transferred cannot be adequately identified, the stock sold or transferred shall be charged against the earliest of such lots purchased or acquired in order to determine the cost or other basis of such stock and in order to determine the holding period of such stock for purposes of subchapter P, chapter 1 of the Code. If, on the other hand, the lot from which the stock is sold or transferred can be adequately identified, the rule stated in the preceding sentence is not applicable.

60. No objection can be made to such a system on behalf of purchasers of stock in such offering since the capital component possibilities presumably will be disclosed adequately as a result of the requirements of the federal and state securities laws. In theory, the issue price of such stock will be discounted by an amount necessary to reflect the risk of liquidation and the difference between issue price and capital component and dividend history. It will be noted that the holders of common stock unsold in the offering have obtained a step-up in their capital component without any additional capital contribution on their part. No one, however, has been defrauded by such step-up. The purchasing shareholders were aware of this result before their purchase. The total tax upon liquidation of the corporation will be based on the total contributed capital of the corporation and thus the treasury will not be shortchanged. Additionally, the step-up is merely incident to an issuance of shares for the business purpose of enhancing the continued operation of the corporation. Upon a sale by the continuing shareholders their basis in the shares will have been unaffected by the step-up in the capital component and their gain on such shares will be the excess of sale price over basis. Thus, since the transactions will not occur in contemplation of liquidation, objection to a step-up in the capital component of the shares held by shareholders prior to and after a new offering may be regarded as an insignificant problem.

ordinary gain than his or her own "actual" capital contribution would entitle him or her. Conversely, the purchaser of shares in the public offering will recognize more imputed ordinary gain than his or her "actual" contribution ($100) would entitle him or her. Under such view it would be appropriate, therefore, to require each pre-offering shareholder in the event of an exchange transaction to use the capital component which his or her own actual capital contribution entitles him or her (in this case $50). In the event of his or her sale of the shares, the purchaser would take the shares with the same capital component as the other publicly traded shares, which capital component would, however, depend on the number of pre-offering outstanding shares still in the hands of its original owners.[61]

The problems resulting from the sliding capital component approach can be shown by considering two subsequent public issues of treasury stock by Corporation A, the first being 1,000 shares at $200 per share, and the second being 2,500 shares at $75 per share. The following table illustrates the capital component effect of these issues under both approaches to capital component outlined above.

TABLE III

Capital Component of	1st approach*	2nd approach**
AFTER FIRST ISSUE		
original 500 shares	$ 80	$50
purchasers of first issue	$ 80	$80-$ 87.50
AFTER SECOND ISSUE		
original 500 shares	$114.29	$50
purchasers of first issue	$114.29	$80-$ 87.50
purchasers of second issue	$114.29	$114.29-$200.00
AFTER THIRD ISSUE		
original 500 shares	$ 97.92	$50
purchasers of first issue	$ 97.92	$80-$ 87.50
purchasers of second issue	$ 97.92	$114.29-$200.00
purchasers of third issue	$ 97.92	$75-$ 97.92

*The first approach is the method whereby the capital component of all outstanding stock is averaged.

**The second approach is the averaging of only those shares actually included in the issue.

61. This approach can be theoretically justified by picturing the original public offering as including all 2,500 shares of the corporation, with the purchasers to be construed as buying 1,000 shares from the old shareholders and 1,500 shares from the corporation with the resulting capital component for each share of $80. However, 500 of the shares of stock (that not included in the public offering) is not to be sold until some later date. If none of the withheld shares are sold before liquidation, or are redeemed, then the capital component of the shares actually sold in the public offering would be $87.50. If some, but not all of the withheld shares are sold before

3. Comparison of Two Methods of Allocation

The above chart shows that the use of the sliding capital component calculation would create extensive bookkeeping problems for companies. More importantly, it indicates that in the publicly held corporation the sliding capital component system is not more equitable than the immediate averaging of capital component system. While the sliding capital component may prevent the pre-offering continuing shareholders from, in the view of some, obtaining an unjustified step-up in their capital component, it does not solve the problem of subsequent purchasers after the public issue. Are these subsequent purchasers to be given an average capital component or are they also to be given a sliding capital component depending on which shares are ultimately sold? If they are to be given an average capital component, then the total contributed capital of the corporation will not equal the total capital component of its outstanding shares until all outstanding shares have changed hands once. If they are to be given a sliding capital component, then the amount of their capital component will not only be uncertain, but the investor will lack knowledge as to the likelihood of sale by holders of low capital component or high capital component shares. It is submitted that it is equitable to use the average capital component approach whereby the capital component of all outstanding shares are averaged with the capital contributed for newly issued shares, and the use of such approach for publicly-held corporations is the only feasible means of implementing a system which attempts to take into account originally contributed capital in measuring imputed ordinary gains on redemptions, liquidations, or distributions which would be dividends but for the absence of earnings and profits.

It should be remembered that a publicly-held corporation will still have a means of preventing the averaging of capital components upon a new issue of stock. For instance, a company having a low capital component for its existing shares, a deficient dividend account, and a somewhat speculative future, might feel that a new issue would find greater investor acceptance if the shares to be issued were to take a capital component equal to the issue price, rather than a lower averaged capital component. Such a corporation could accomplish the capital component-issue price equivalency by issuing a new class of stock.

The situation of the small closely-held, privately traded corporation

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liquidation then the capital component would be adjusted downward accordingly. Thus, purchasers take their shares with a sliding capital component, the parameters of which are known, but the exact amount of which varies depending from time to time on the number of originally withheld shares still unsold. This approach would seem to be equitable, but one would have grave doubts as to its practicality.

is different. Since buyers and sellers have a direct relationship, and since complex capital structures are unlikely to arise, it is suggested that closely-held, privately traded corporations would be able to use the actual contributed capital for their shares as its capital component, rather than the average capital component method. Each closely-held corporation could elect the method of capital component computation by which it wished to be governed, such election to be accomplished by such methods as the Internal Revenue Service should direct. Upon going public, a corporation would be governed by the average capital component method.[62]

B. Capital Component and Convertible Stock

Convertible stock or securities presents a different problem. Suppose Corporation ABC has since its incorporation had outstanding 100 shares of common stock having a capital component and original fair market value of $10 per share, and 100 shares of preferred stock having a capital component and original fair market value of $20 per share which preferred stock is convertible one share for one share into common stock. If the corporation is privately held and on the actual capital component method, the conversion of forty shares of preferred into common will result in the newly outstanding common having a capital component of $20, the same as the preferred from which it was converted.

If ABC were publicly held and forty preferred shares were converted to common, is there a way to justify the use of the average capital component netted? One possibility would be to require the averaging of the capital component upon the issuance of the convertible securities as if the securities holders had received common stock at the outset. The later conversions would cause no change in the capital component. This approach might be acceptable for corporations with

62. Suppose that a privately-held Corporation XYZ has elected to use the actual capital component method, and has three shareholders A, B, and C owning ten shares of common stock each. A's shares have a capital component of $10 per share, B's shares have a capital component of $20 per share and C's shares have a capital component of $25 per share. XYZ plans to go public by issuing 100 shares of common stock at $100 per share. None of the original shareholders is selling any of his or her shares in such public issue. The capital component of the 130 shares which will be outstanding after the public offering will be $81.15 determined by dividing the total contributed capital of the corporation by the number of outstanding shares. The result is understood by visualizing the capital formation history of XYZ as follows: A forms XYZ for a capital contribution of $100, receiving in exchange 10 shares of XYZ common; XYZ issues 10 shares of common to A for $20 per share, giving A an average capital component of $15 per share for each of his 20 shares; XYZ issues 10 shares of common to A and 5 shares to B for $25 per share, giving both A and B an average capital component of $18.33 for their shares; A and B each sell their last acquired 5 shares to C at their cost of $25 per share; XYZ issues 33⅓ shares of common stock each to A, B, and C for $100 per share, giving A, B, and C an average capital component of $81.15 for their 43⅓ shares; A, B, and C each sell their last acquired 33⅓ shares in a public offering for their cost of $100.

clearly sufficient dividend accounts since the preferred shareholders would not, therefore, face a risk of imputation of ordinary gain on redemptions, an event quite likely to occur in case of preferred stock. For corporations which are not Fully Qualified Corporations, there would always be the possibility of creating a new class of common into which the preferred may be converted. Still the feeling remains that perhaps convertible stock is a unique animal which should retain its actual capital component until conversion occurs. Unlike the case of various issues of the same class of stock with different capital components where resale cannot be predicted, and where fluctuations in the capital component of shares would occur almost daily in the absence of the immediate average capital component approach, convertible securities are likely to be limited as to the period in which conversion may occur, to all be converted when the market price of the stock into which it is convertible becomes attractive, and, in any event, to be redeemable enabling the corporation to eliminate capital component problems by redemption if it wishes. Moreover, the likely timing of a change in capital component and its effect on the capital component of the shares of the same class into which it is converted, can be much more readily described to, and understood by, investors. Accordingly, it would appear appropriate to allow a publicly-held corporation to elect to have capital component adjustments in the case of convertible securities made either on their issuance (average capital component method) or upon actual conversions.

C. Capital Component Computations in Reorganizations

Another concern in the use of the capital component concept is the area of reorganization. Tax-free reorganizations may be broken down into two categories — those resulting in the amalgamation of previously existing corporations[63] and those resulting in the division of an existing corporation.[64] In the latter category of tax-free divisive transactions, there also may be included divisions of a corporation in transactons other than a reorganization.[65]

From a capital component standpoint, divisive transactions are less troublesome than amalgamating ones. Divisive transactions will require the allocation of existing equal capital components among the shares of the resulting entities so as to retain the equality within each class of stock and securities. Amalgamating transactions will result in exchanges of stock having different capital components, and will

63. Tax-free amalgamating transactions are reorganizations defined in I.R.C. § 368(a)(1)(A), (B), (C), (D) (but only if the requirements of I.R.C. § 354(b)(1) are met), and (F).

64. Tax-free divisive transactions are those which meet the requirements of I.R.C. § 355.

65. I.R.C. § 355(a)(2)(C).

require a method of amalgamating the capital component of the resulting outstanding shares. As with new issues and convertible stock, the treatment of capital component will be critical in the case of publicly held corporations, with the average capital component approach being applied where necessary to avoid impairment of the stock market.

The capital component of stock or securities distributed in a tax-free corporate division should, as with the basis of such stock or securities, be determined in accordance with the general principle of section 358 of the Internal Revenue Code. Thus, the capital component of the stock and securities previously held by the recipients of the divisive distribution will be allocated in accordance with relative fair market value among the newly received stock and securities and the retained stock and securities, subject to additions and subtractions as described in section 358(a)(1)(A) and (B). Since an amalgamation is not involved, such allocation presumably will involve stock and securities, each class of which has a common capital component for its constituent securities. The allocation of capital component between stock and securities received in exchange for existing stock or as a distribution in respect thereof, and the existing or retained stock, will not cause the capital component of particular shares of stock within a class of new or retained securities to differ from one another.

An amalgamating transaction will often result in stock of different corporations, and thus different capital components, being exchanged for shares of the same class of stock of one corporation. In a privately traded corporation, the general rule of section 358 may be extended to the determination of capital component so that the capital component of a share received in a tax-free amalgamating exchange will retain the capital component of the stock surrendered. As with new issues of stock, such a result would be unworkable in a publicly traded corporation. A look at various amalgamating transactions and their effect on the capital component of the shares of the resulting corporation will show how capital component problems must be handled in amalgamating reorganizations. In this regard, the following example is illustrative:

Corporation A
10,000 shares of common stock
Capital component — $50,000 ($5 per share)
Fair Market Value — $500,000 ($50 per share)

Corporation B
20,000 shares of common stock
Capital component — $400,000 ($20 per share)
Fair Market Value — $1,000,000 ($50 per share)

Consider first an A reorganization, where A and B are to be consolidated into AB, with shareholders of A and B receiving one share of the common stock of AB for each share of A and B, respectively, surrendered in exchange. A closely held corporation would be entitled to use the actual capital component method. Under the actual capital component method each share of A common stock would be exchanged for a share of AB common stock having a capital component of $20 per share.

Publicly held companies would use either the two class common approach or the average capital component approach. Under the two class common approach, a corporation would achieve the same actual capital component result as outlined in the immediately preceding paragraph, with each surrendered share's capital being passed on to the shares of AB common received in exchange. Former A shareholders would hold AB class A common and former B shareholders would hold AB class B common. Under the average capital component approach the shareholders of A and B would receive one share of AB common stock having a capital component of $15 per share for each share of A or B common stock, respectively, surrendered. This result is justified by the rationale that the shareholders of A and of B have decided to pool their investment.[66]

D. *Capital Component and Stock Outstanding Prior to Effective Date of Proposal.*

Having examined the effect of the capital component concept on share transactions occurring after the effective date of any new legislation, it is now necessary to consider the consequences of such a change on existing outstanding stock issued at many different prices and with many different bases. Assume a corporation with one class of common stock outstanding, which stock was issued as follows: 1,000 shares at $50 per share; 1,500 shares at $100 per share; 1,000 shares at $200 per share; 2,500 shares at $75 per share. Immediately allocating the capital component on an averaging approach among all shares would result in a capital component of $97.92 per share.

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66. Thus it is as if the A shareholders transferred pro rata ⅔ of their shares (6,666⅔ shares worth $50 per share) for ⅓ of the shares of B (6,666⅔ shares worth $50 per share) also transferred pro rata by the B shareholders. The effect of such hypothetical transaction is that the former shareholders of A now own 3,333⅓ shares of A and 6,666⅔ shares of B. The former shareholders of B now own 6,666⅔ shares of A and 3,333⅓ shares of B. The fair market value of the holdings of each set of shareholders is unchanged, but the average capital component of the holdings of each set of shareholders is now $15 per share. The shareholders of A and B now exchange their mixture of ⅓A and ⅔B shares for shares of AB. Similar analysis applied to B and C reorganizations and to amalgamating D and F reorganizations would yield the same treatment options for the corporations and shareholders involved.

Objection on equitable grounds might be made to legislation resulting in the immediate use of $97.92 as the capital component of stock held by existing shareholders, since shareholders have purchased shares in the anticipation that such purchase price will be their basis for section 331 exchanges in complete liquidation. Accordingly, shareholders who purchased or were issued their shares at prices above the average capital component will feel that such purchase price should constitute the capital component of their shares.

A delayed form of implementation would allow all present holders of stock to use as the capital component of their stock the price at which it was purchased. Purchasers after the effective date would take the stock purchased with an average capital component (of $97.92 in the above example). This approach, however, would result in the total contributed capital and the total capital component of all shares being unequal until all shares held before the effective date have been sold. Moreover, allowing holders of stock on the effective date of any legislation introducing the capital component concept to continue indefinitely to utilize their present bases in lieu of capital component would be an unhealthy inducement to such shareholders to retain shares they might otherwise sell. Accordingly, it might be appropriate to stay the effective date of the earned capital gains treatment proposed in this article until a period of years after its passage, with the averaging of all existing shares within a class resulting even for pre-legislation shareholders on such effective date. This would allow time for the impact of such legislation to be explained to investors and allow investors an opportunity to adjust portfolios. The Commissioner could be authorized to grant exceptions to such averaging of capital components in appropriate situations. Regulations also might be necessary to handle the problem of corporations, if any, whose records do not contain all information necessary to trace back capital component; it would seem unlikely that many corporations would be unable to determine their total capital component.

The above analysis of the capital component problems caused by various issues of stock of the same class, by conversions of stock from one class into another, and by amalgamating reorganizations, suggests that such concept, while certain to produce complexity of definition and example in the Internal Revenue Service Regulations, could be utilized without unduly impairing the functioning of the stock market. The general principle would be to require each share of a class of stock to have a common capital component with other shares in such class, except for stock of privately-held companies which elect to use the actual contributed capital approach. Implementation of such proposal would be delayed for a period of time to allow the effect of such changes to be understood and adjusted for by investors.

E. Capital Component and Sections 305 and 306

An area of concern in utilizing the capital component concept is sections 305 and 306 stock. What is the capital component of stock distributed in a distribution described in section 305(b) of the Internal Revenue Code? Upon formation of a corporation, the capital component of shares issued in exchange for contributed property is the amount of the money plus the basis in the hands of the transferor of other property contributed. Such money or property to the extent of its basis in the hands of the transferor has been fully taxed. Stock distributed in a distribution described in section 305(b) will be taxed to a recipient as if he or she had received from the corporation a money dividend equal to the fair market value of the stock received and had then purchased from the corporation, with fully taxed funds, the stock so distributed. Accordingly, the capital component of stock distributed as described in section 305(b) should equal its fair market value. As we have seen with the public issue of shares where existing shares are outstanding,[67] the possibility of different capital components for stock of the same class must be avoided. The types of situations covered by section 305 and the capital component adjustments necessitated by each situation are discussed below.

The first situation is two class common stock where each share of each class is entitled to share equally in the assets and earnings of the corporation.[68] If one class receives a dividend payable in cash and one class receives a dividend payable in additional shares of such class, then the additional shares are treated as a distribution of property under section 301 to the extent of their fair market value. Accordingly, the capital component of all shares of the class receiving such stock dividend should be determined immediately after such dividend by adding the contributed capital of such class before the dividend and the total fair market value of the stock dividend, and then dividing the sum so obtained by the total number of shares of such class outstanding after such stock dividend.

The second situation would be distributions of convertible preferred stock treated under section 305(b)(5) as a distribution of property to which section 301 applies. Such convertible preferred will take as its capital component its fair market value, and the stock as to which it was issued will take a sliding capital component with adjustments occurring upon conversions. The limits of the changes in capital component

67. *See* discussion of Publicly Held Corporations, Section III(A)(3) *supra*.

68. *See* Treas. Reg. § 1.305-3(e), *Example 1*.

which will result if conversion ultimately occurs can be set at the time of the issuance of the convertible stock.[69] Since convertible preferred stock will not be subjected to treatment as a distribution subject to section 301 unless it appears likely that some of such convertible stock will be converted into stock and some into money, and since a short duration of the right of conversion is one of the factors leading to such a conclusion, the sliding capital component will likely become an average capital component within a reasonable time after the dividend.

A third area covered by section 305(b)(2) is distributions resulting in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders. In a privately traded corporation electing actual capital component treatment, the shareholders receiving stock have their capital component allocated between the old and new stock in the same manner as stock distributed in the two-class common situation described above. Subsequent purchasers of such class of stock take such stock with a sliding capital component which adjusts as subsequent sales are made. In electing privately held corporations and in publicly traded corporations, unless the two-class common approach was used, the transaction would be viewed as a pro-rata stock dividend to all shareholders resulting in an average capital component, followed by a sale of the dividend stock to the actual stock dividend recipients.

Section 305 also deals with the consequences of increasing and decreasing conversion ratios, and the issuance of common on common where no adequate anti-dilution provision exists for outstanding convertible securities. The capital component of stock whose conversion ratio is increased would be adjusted by increasing such capital component by an amount equal to the increase in the fair market value of such stock treated as a distribution of property subject to section 301. If the conversion ratio of convertible stock is decreased, the capital component of the stock into which it is convertible is increased by the fair market value of such change (the amount treated as distribution of property subject to section 301). In the absence of adequate anti-dilution provisions for outstanding convertible securities, the capital component of common stock will be the capital component of the pre-dividend shares averaged as in the two class common example. In the case of a proscribed original issue discount, the capital component will be increased as, and to the extent that, such premium is treated as a distribution of property subject to section 301. Stock which is not pursuant to section 305(b) or (c) treated as a distribution of property subject to section 301 will not be subject to taxation upon distribution.

69. *See* Section III(B) *supra.*

Some of such stock (section 306 stock) will la r be subject to dividend treatment under section 306 upon its disposition, while other of such stock will not. Additionally, section 306 stock includes certain stock received in a reorganization or in an exchange under section 355. Section 306 stock is not subject to dividend taxation until it is disposed of and then only if it is not disposed of in a transaction satisfying one of the exceptions set forth in section 306(b) or (c). Because the eventual tax burden imposed on section 306 stock cannot be determined until its disposition, it seems essential administratively to require that the capital component of all stock or stock rights received in a distribution to which section 305(a) applies be determined by allocating between the old stock and the new stock the capital component of the old stock. This could be accomplished pursuant to regulations of the Commissioner as under section 307.[70] The consequence of such a structure is that a purchaser of section 305(a) stock will take such stock with a capital component other than the purchase price which he or she pays, even though the seller will have incurred dividend treatment on the sale proceeds. Under the suggested treatment of section 305 transactions as being the equivalent of a section 351 contribution of tax paid funds, a purchaser of section 306 stock ideally would be entitled to a cost capital component for his or her shares, but such is not feasible. Presumably this fact will be considered by a purchaser if the purchaser is other than a tax-exempt entity. Of course, if the corporation is by its dividend history a Fully Qualified Corporation, then a purchaser of section 306 stock would not be concerned by this problem.

IV. TAX AVOIDANCE AND CARRYOVER OF DIVIDEND ACCOUNT

A proposition often cited by those commenting on the practicability of treating the gain realized on liquidating distributions as other than capital gain is that such proposals are "open to ready avoidance by sales in anticipation of liquidation to low-bracket or charitable entities."[71] To this and other possible tax avoidance problems which must be anticipated in implementing the proposals, this article now turns.

If one rejects scrutinizing each sale of shares of an on-going corpora-

70. I.R.C. § 307(a) sets forth the following general rule:

If a shareholder in a corporation receives its stock or rights to acquire its stock . . . in a distribution to which section 305(a) applies, then the basis of such new stock and of the stock with respect to which it is distributed . . . respectively, shall, in the shareholder's hands, be determined by allocating betweeP the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be determined by allocating between the old stock and the new stock the adjusted basis of the old stock. Such allocation shall be made under regulations prescribed by the Secretary.

71. H. CALKINS, 86TH CONG. 1ST SESS., CORPORATE DISTRIBUTIONS AND ADJUSTMENTS AND THE HARD ROAD TO A BROADER TAX BASE 1639 (Comm. Print 1959).

tion for its then eligibility for full capital gains treatment based on the dividend history of the corporation at such time,[72] the problem of anticipatory sales or gifts to low-bracket or tax-exempt entities may be approached in one of two ways. Emphasis may be placed either on the treatment of recipients of such sales or gifts, or upon the transferors, based upon a general notion that it is not acceptable to obtain tax benefits by participating in transfers made in anticipation of liquidation or redemption.

Looking first at charitable gifts to tax-exempt entities, if one wishes to prevent charitable gifts being made in anticipation of liquidation by focusing on the donor, then what should the protective measure be? Present law favors charitable contributions of stock by allowing a deduction against ordinary income in the amount of the fair market value of stock, rather than in the amount of the shareholder's basis for these shares.[73] One way of stating this is that Congress will allow an individual to receive a deduction against ordinary income for the value of contributed shares by foregoing the opportunity to sell such shares with gain, if any, being entitled to capital gains treatment. Contributions of shares in collapsible corporations or of section 306 stock would infringe on this *quid pro quo* since the gain being foregone would not have been entitled to capital gains treatment. However, section 170(e)(1)(A) of the Tax Reform Act of 1969, reduced the charitable deduction available by the amount of ordinary income which a sale of the contributed property by the donor would have produced. A gift in anticipation of the liquidation of a Non-Fully Qualified Corporation would involve the avoidance of ordinary income, the exact problem which Congress addressed in section 170(e)(1)(A). Accordingly, it is suggested that section 170(e)(1) be amended so that the charitable deduction for any donation of shares of stock in a Non-Fully Qualified Corporation should be reduced by the amount of ordinary income which would be realized by such donor if the corporation were completely liquidated on the date of such gift.[74] Such a provision should deal effectively with the possible tax avoidance problem of gifts to tax-exempt entities by the

72. *See* discussion of *Complete Liquidation,* Section II(A) *supra.*

73. Treas. Reg. § 1.170-1(c) provides as follows: "If a contribution is made in property other than money, the amount of the deduction is determined by the fair market value of the property at the time of the contribution."

74. Thus if shareholder H-1, the original incorporator of Corporation H which has a zero dividend account, donates his shares in H (having a capital component of $100 and a fair market value of $2,300) to a charitable institution, his deduction will be $100 since the amount of ordinary income recognized in the event of complete liquidation would have been $2,200. If H had paid dividends of $500 prior to the gift, making the fair market value of H $1,800, then H-1 would be entitled to a deduction of $500, the fair market value of his stock less the amount of ordinary income which would have been incurred in a complete liquidation occurring on the date of the gift.

shareholders of Non-Fully Qualified Corporations.[75]

Focusing preventive measures on the recipient of stock in such a tax avoidance situation seems unnecessary since the preventive measure aimed at donors just described effectively deals with the possible problem. Moreover, a mere recipient of a gift may be thought of as an inappropriate entity to tax, as opposed to the donor, where the recipient has not participated in the transaction in any manner other than would be thought appropriate of a charity.

The measures necessary to prevent sales to low bracket or tax-exempt entities would depend on the situations in which such sales are likely to occur. In a closely-held corporation, these sales would likely occur as an integral part of the liquidation process. The shareholders of a closely-held Non-Fully Qualified Corporation desiring to liquidate, but not wishing to bear the tax burden resulting from the corporation's dividend history, would attempt to find an entity, probably tax-exempt, which would purchase their shares, giving the sellers capital gains treatment. The tax-exempt entity would subsequently liquidate the corporation recovering tax-free its investment plus the negotiated premium.

In the publicly-held situation, the anticipatory sales are more likely to involve the dumpings of shares on the public market by high bracket entities and people whose cost basis for shares exceeds the capital component. Corporation H with a fair market value of $2300 and a capital component of $100 for its outstanding shares, all held by the original incorporator and sole shareholder H-1, shows the tax advantages which would cause shareholders to wish to sell their shares in contemplation of liquidation. The tax to H-1 if he caused corporation H to liquidate would be $1540, whereas if he sold his shares for $2200 (a liquidating distribution would be $2300) to a tax-exempt entity, then his tax is $735. The after tax yield to H-1 is $705 more if he sells his shares instead of liquidating. The tax-exempt entity will then liquidate H receiving tax-free the return of its $2200 investment plus a $100 premium.

Focusing preventive measures on the seller of stock in contemplation of liquidation would require a provision that any sale in contemplation of liquidation would be allowed capital gains treatment only to the extent that the dividend history of the corporation would have qualified an exchange in liquidation occurring on the date of sale for capital gains treatment. In a closely-held business, particularly one where the corporation's value is largely in passive investments such as real estate, it may be difficult to determine whether sales have occurred in contempla-

75. In addition, such a provision, coupled with the earned capital gains tax treatment for redemptions concept, might be helpful in the life income cases. *See, e.g.*, Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973).

tion of liquidation. Suppose the major asset of H, other than cash, is a shopping center managed by a management company unrelated to H-1. If H-1 sells his shares to a tax-exempt entity for $200, the transferee may well be prepared to wait several years before liquidating the corporation. Accordingly, it may be necessary to provide that any sale of shares to a tax-exempt entity, other than sales which are made over the counter or on a public exchange, should result in capital gains treatment to a seller of shares only to the extent qualified by a dividend deduction determined as of the date of sale, regardless of whether such sales are made in contemplation of liquidation.

Sales by shareholders of a publicly-traded corporation would be easier to police. The disclosure requirements of the various securities laws will require notice of any planned liquidation.[76] From the date knowledge of a possible liquidation is disseminated, all sales of shares should be entitled to capital gains treatment only to the extent of the corporation's dividend account, with imputed ordinary gain if applicable, except that if a decision is made not to liquidate then such seller of shares would be entitled to full capital gains treatment. A purchaser of shares during such a limbo period would be entitled to use his or her cost basis as capital component if liquidation in fact occurred, but not otherwise.

Redemptions will create a different problem in some respects than liquidations. A person who sells his or her shares in the market with knowledge that an offer to redeem is outstanding, must be thought to be selling in contemplation of such redemption. To taint all such sales would inhibit the stock market. Perhaps the best course is to impose a seventy per cent tax on the gain (redemption price minus capital component) of all shares voluntarily tendered for redemption by a tax-exempt entity, unless all of such shareholder's holdings in such company were acquired prior to the making of such tender offer and prior to such entity's knowledge that then an offer would be made, or unless the corporation has been a Fully Qualifying Corporation since the shareholder became a shareholder. Another possibility is to suspend the automatic full capital gains treatment for sales of shares during periods in which an offer to redeem is outstanding. Thus, a company would be reluctant to attempt to redeem its shares unless such redemption would be a fully qualifying one. Since automatic capital gains treatment on sales of shares is extended under the proposals made earlier in this paper on the understanding that such treatment will result in imputed ordinary gain upon liquidation if dividends have not been sufficient, it seems wholly appropriate to suspend such privilege when a

76. *See* note 52 *supra*, where the need for additional legislation is explained.

portion of the corporation's assets are permanently leaving the corporation without the required settling up.

The value of a dividend account under the proposed earned capital gains concept will make necessary rules governing the carryover of such attribute in the event of corporate divisions, mergers and other reorganizations, and will make necessary rules governing other transactions whereby individuals or corporations attempt to avoid the tax consequences of the lack of a sufficient dividend account.

The shareholders of a corporation having a poor dividend history but substantial asset value who wished to cash in their investment at capital gains rates, and without recognition of imputed ordinary gain, would attempt to find a purchaser for their shares. If such purchaser were other than a corporation then there would be no objection to such transaction since corporate assets would not thereby leave corporate solution and their future leaving of corporate solution by way of liquidation or redemption would remain subject to the sufficiency of the dividend account for any capital gains treatment and subject to imputed ordinary gain. Earlier in this section,[77] the possible ways of penalizing shareholders who transferred shares to a tax-exempt entity in order to avoid the tax consequences of an insufficient dividend account were discussed. Would such measures apply if a shareholder sold all of his or her shares to Corporation X in contemplation of liquidation and X did in fact liquidate under section 332 and step-up the basis of the old corporation's assets under section 334(b)(2)? The answer may differ depending on the circumstances. If a corporation is closely-held, it is difficult to believe that negotiations between seller and purshaser would not cover all factors affecting the value of the seller's property, including the intended use of such property by the purchaser. If the purchaser expected a cost basis for its assets, as opposed to a continued operation of the corporation in its present form, such fact would likely be available to the seller. Clearly not covered by the above-described methods for attempting to prevent the avoidance of tax by transfers in contemplation of liquidation would be transactions in which the purchasing corporation operates the sold corporation for several years and then liquidates under Code section 332.

Sales to a corporation would of course be a problem under present law because section 332 allows a corporation to receive a distribution in complete liquidation of an eighty per cent subsidiary without recognition of gain or loss. Section 332 is a logical provision when one considers subsidiaries of a corporation formed by its parent, but it makes very little sense in the case of a corporation which purchases an existing

77. *See* pp. 129-32 *supra*.

corporation which does not fully qualify for capital gains treatment for its own exchange transactions. The dividend account of the purchased corporation would be carried over as discussed immediately below.

It is suggested that section 332 should be amended so that upon liquidation of a corporation which was not formed by its parent and which was dividend deficient upon its purchase, the parent shall recognize gain under section 331. Code section 243 must also be amended to prevent a corporation from distributing the property of a purchased subsidiary to itself over a period of time to avoid the consequences of the proposed revision of section 332. The benefits of section 243 should be unavailable to a corporate purchaser of eighty per cent of the shares of a Non-Fully Qualified Corporation, and all distribution by such subsidiaries should be subject to treatment under section 301 as if the parent were a non-corporate distributee until such time as the corporation becomes a Fully Qualified Corporation (its dividend account matches its net asset value). The amended sections 243 and 332 would be inapplicable to such a corporate purchaser once its subsidiary became fully qualified.[78]

Because of the danger of a corporation acquiring less than eighty per cent of the stock of a Non-Fully Qualified Corporation and before reaching eighty per cent causing such corporation to pay dividends to its parent which qualify for the eighty-five per cent dividend deduction of section 243, until sufficient dividends have been paid to make such corporation Fully Qualified, it is suggested that section 243 be further amended to be inapplicable to any distributions to a corporate shareholder by a corporation which was non-fully qualifying on the date such corporate shareholder became the owner, including attribution under section 318, of twenty per cent or more in value of the stock of such distributing corporation. These further provisions of section 243 would not apply to shares received by a corporation in a tax-free exchange or after the time when the distributing corporation becomes a Fully Qualifying Corporation.

A similar type of treatment could be used for tax-exempt purchasers of stock in a Non-Fully Qualifying Corporation. Such a provision would in effect say to tax-exempt entities, "your tax-exempt privilege does not extend to certain transactions where you assist, knowingly or unknowingly, the avoidance by individuals of the tax burden which Congress wishes to impose on certain distributions of corporate

78. Thus if X Corporation purchased all of the stock of Y Corporation from the Y shareholders, and if Y Corporation has a net asset value of $200 (fair market value minus total capital component), a dividend account of $160, and earnings and profits of $20, then the distribution of a $20 dividend by Y immediately after the purchase by X would make Y a Fully Qualified Corporation and would make the special provisions of the amended §§ 243 and 332 inapplicable thereafter.

assets." No great burden is placed on tax-exempt entities by such a provision since their exposure is determinable and fixed as of the date of their purchase of a share.

Reorganizations create problems of how to carryover the dividend account in a way which will prevent the trafficking in dividend accounts. This is important so that the concept of a minimum requirement which must be satisfied to warrant full capital gains treatment does not become a measure of maximum burden. It is suggested that in a B or E or non-amalgamating F reorganization the dividend account should carryover, with the B reorganization acquiring corporation being subject to the special provisions of sections 243 and 332 if the acquired corporation were not fully-qualified on the date of the transfer. A D reorganization constituting a "split-up" or involving the transfer of operating assets only, rather than substantially all of the transferor's assets would result in allocation of the dividend account as with earnings and profits under section 312(i) of the Internal Revenue Code. An A, C, D (not described in the preceding sentence), or amalgamating F reorganization would result in a carryover of the dividend account, but to the extent that the acquiror or acquiree (or both if a consolidation) was not a Fully Qualified Corporation prior to the reorganization, then the resulting entity's dividend account shall reflect such prior deficits. Such post-reorganization deficits should be capable of alleviation only by post-reorganization dividends which, pursuant to regulations of the Commissioner, are determined to be attributable to the assets of the pre-organization entity to whom the deficits are attributable.

V. CONCLUSION

The present system of corporate-shareholder taxation favors corporate liquidators, and provides no rewards to the continuing corporation which submits to the double taxation of corporate gain. This article has demonstrated that the double tax system can be strengthened, and the bias against continuing corporations alleviated, by allowing corporate distributions which are not dividends to be treated as capital gains only to the extent that the gains on such distributions are matched by lifetime dividend payments made by the corporation.

Certainly, this proposal would introduce into the tax system some new complexity. However, this proposal would make possible the elimination of the extremely intricate and overly broad collapsible corporation provisions. Thus, it may reasonably be argued that no overall net increase in complexity would result by the proposal's adoption.

One effect of this proposal would be the imposition of equal tax burdens on like corporations or their shareholders regardless of the manner in which the corporation is organized or its affairs conducted. Finally, the proposal provides a much needed theoretical justification for the preferential treatment of corporate distributions which are other than dividends.