

## Current Trends in the Taxation of Stock Distributions

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## CURRENT TRENDS IN THE TAXATION OF STOCK DISTRIBUTIONS

The recently announced three-for-one stock split by American Telephone & Telegraph Company piqued the interest of many other than those fortunate enough to be shareholders.<sup>1</sup> But the interest of the businessman and attorney in corporate distributions of stock, whether in the form of a stock dividend or a stock split, never slumbers deeply. The extreme differences in tax treatment between property and stock distributions have continually motivated attempts to channel distributions into the latter category.<sup>2</sup> Moreover, with the lifting of the thirteen-year boon of tax-exempt stock dividends in 1934,<sup>3</sup> the possible frustration of the use of such dividends by unfavorable tax consequences has become a matter of increasing concern.

For the first time since the enactment of subchapter C of the 1954 Code, the Legislature is giving this subchapter a thorough going over. Following in the wake of the *American Law Institute Tax Project Report*, which expressed the tentative results of the committee's two-year study in the area of corporate taxation,<sup>4</sup> the Subcommittee on Internal Revenue Taxation of the House Ways and Means Committee (the "Mills Committee") recently introduced its proposed amendments to subchapter C.<sup>5</sup>

It is the purpose of this note to review the area of corporate distributions of stock in light of the ALI recommendations and the Corporate Distributions and Adjustments Bill of 1959. The discussion will be limited to the tax consequences of stock distributions,<sup>6</sup> with special emphasis on the creation and treatment of section 306 stock.<sup>7</sup>

*Stock Splits*

All other things being equal, the stock split has the same actual value to shareholders as a stock dividend. Likewise, the main utility

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<sup>1</sup> In fact CCH felt called upon to issue a rewrite bulletin dealing with the tax consequences of this split. See 6 CCH 1959 STAND. FED. TAX REP. ¶8783.

<sup>2</sup> See ALI FEDERAL INCOME, ESTATE AND GIFT TAX PROJECT REPORT, INCOME TAX PROBLEMS OF CORPORATIONS AND SHAREHOLDERS 74 (Oct. 31, 1958). [Hereinafter cited as ALI TAX PROJECT REPORT.]

<sup>3</sup> Section 115(f)(1) of the Internal Revenue Act of 1934 [48 Stat. 712], which imposed a tax on all stock dividends, brought an end to the tax-exempt status of such dividends provided in §201(d) of the 1921 act. [41 Stat. 228].

<sup>4</sup> See ALI TAX PROJECT REPORT vii.

<sup>5</sup> Corporate Distributions and Adjustments Bill of 1959, H.R. 4459, 86th Cong., 1st Sess. (1959).

<sup>6</sup> Contained generally in INT. REV. CODE OF 1954, §§ 305-07. [Hereinafter cited as CODE.]

<sup>7</sup> CODE § 306.

of both a split and a dividend is the same: the shareholder's interest is put in a more convenient form for sale.<sup>8</sup>

A split-up results in the reduction of par or stated value or, in the case of true no-par stock, a reduction of the amount of consideration allocated to capital with respect to each share, and is accompanied by a proportionate increase in the total number of shares. There is no change in the legal or stated capital, nor does the shareholder receive any extra value.<sup>9</sup> Professor Ballantine's simile is particularly apt: "... simply a dividing up of outstanding shares . . . like changing a five dollar bill into 'ones.'" <sup>10</sup>

A stock dividend is a pro rata distribution of additional shares to shareholders. The distribution does not effect any change in the par or stated value of the original shares. The actual value of the shares is diluted, since the aliquot share of the corporate assets represented by the original shares is spread over all the shares. Since an issue of stock without consideration is generally prohibited by state law, surplus must be transferred to capital. Thus, in this case, there is a change in the legal or stated capital. Where the distribution is of common stock with respect to outstanding common stock, the shareholder cannot be said to have received any extra value. Where, however, a different class of stock is distributed as a dividend, the proportionate interest of the shareholder in the corporation may be substantially changed.<sup>11</sup>

Although there are various changes in the internal capital structure of the corporation for local law purposes depending upon whether a split or a dividend is declared, no change is effected in the capital structure for tax purposes. Neither a split nor a dividend effects any change in earnings and profits.<sup>12</sup>

While, as noted, the value and the utility of these transactions to the shareholder is generally the same, they are essentially different. A split merely divides the form of ownership: the share which represented the shareholder's original investment and its appreciation is exchanged for a different number of shares, each of which represents a proportionate amount of the original investment and its appreciation. A dividend, however, does not disturb the original investment. Rather it effects a reinvestment of the appreciation of the original investment.<sup>13</sup> Further, the capitalization of surplus which must pre-

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<sup>8</sup> See BALLANTINE, CORPORATIONS § 208, at 481-83 (rev. ed. 1946).

<sup>9</sup> *Id.* at 483.

<sup>10</sup> *Ibid.*

<sup>11</sup> *Id.* at 481-83. With regard to change of proportionate interest see, *e.g.*, *Koshland v. Helvering*, 298 U.S. 441 (1936), where a common stock dividend to preferred shareholders, both classes outstanding, was held to change the proportionate interest of the shareholders, and *Helvering v. Gowran*, 302 U.S. 238 (1937), where a preferred dividend to common shareholders, both classes outstanding, had the same effect.

<sup>12</sup> CODE § 312(e).

<sup>13</sup> BALLANTINE, CORPORATIONS § 208, at 482 (rev. ed. 1946).

cede the issue of additional shares limits future dividend distributions by decreasing surplus and increasing the legal capital margin.

Choice between these two courses depends primarily on the availability of surplus and on extrinsic factors which make the capitalization of surplus desirable or necessary for corporate purposes.<sup>14</sup> To the shareholder the stock dividend may have certain disadvantages: through the capitalization, surplus is rendered unavailable for cash dividends. Further, the stock dividend purports to be a symbol of accumulated profits, yet, since the dividend may be charged against re-evaluation surplus or paid-in surplus, it is possible for the corporation to misrepresent its financial condition.<sup>15</sup> A split, on the other hand, neither reduces surplus nor makes any representations concerning surplus.

In the usual case of a distribution of common stock with respect to common stock outstanding or a split of outstanding common stock, the tax consequences are exactly the same. Neither gives rise to income upon receipt.<sup>16</sup> The adjusted basis of the original stock must be allocated over all the shares.<sup>17</sup> Furthermore, neither would result in section 306 stock.<sup>18</sup> Where, however, preferred stock is distributed as a dividend or common stock is distributed with respect to preferred stock, the dividend will come within the operation of section 306 of the 1954 Code<sup>19</sup> and, upon sale or redemption, ordinary income will be recognized.<sup>20</sup> A split of preferred stock, albeit a highly unlikely transaction, would give rise to section 306 stock if the original shares were section 306 stock<sup>21</sup> or if the exchange had substantially the effect of a stock dividend.<sup>22</sup>

<sup>14</sup>Apart from such direct business purposes, a stock dividend may be declared in order to maintain the confidence of the shareholders at a time when a cash dividend is impossible, as, for example, where a corporation does not have sufficient liquid assets. *Id.* at 481.

<sup>15</sup>*Id.* at 482-83.

<sup>16</sup>CODE §§ 305(a) (dividends), 354(a) (splits).

<sup>17</sup>CODE §§ 307(a) (dividends), 358(a) (splits).

<sup>18</sup>CODE § 306(c).

<sup>19</sup>A stock dividend, other than common with respect to common stock, when a corporation has earnings and profits and where no gain or loss is recognized upon distribution, is "§ 306 stock." CODE §§ 306(c) (1) (A), (2).

<sup>20</sup>To the extent of earnings and profits at the time of the distribution in the case of a sale [CODE § 306(a) (1) (A)], at the time of the redemption in the case of a redemption [CODE §§ 306(a) (2), 312(a)].

<sup>21</sup>CODE §§ 306(c) (1) (B) (ii), (c) (2).

<sup>22</sup>Since a stock split is an exchange, not a distribution, it would not be § 306 stock by virtue of § 306 (c) (1) (A). However, it may come within the provisions of § 306(c) (1) (B) (i), *i.e.*, stock, other than common stock received in a recapitalization to which § 368 applies or stock received in an exchange to which § 355 (or so much of § 355 as relates to § 355) applies, ". . . but only to the extent that . . . the effect of the transaction was substantially the same as the receipt of a stock dividend . . ." CODE § 306(c) (1) (B) (ii).

It is unclear, however, how § 306 would be applied to stock splits. Since a stock split leaves no underlying stock, just which of the shares received

### Stock Dividends

#### 1. General Background

The present Code treatment of stock dividends, contained generally in sections 305 to 307, caps forty years of indecisive skirmishes between Congress, the courts, the Commissioner and corporate managers and shareholders. In 1920, a legislative attempt to tax a dividend of common stock with respect of common stock outstanding<sup>23</sup> was struck down on the ground that the receipt of this stock dividend was not income within the meaning of the sixteenth amendment.<sup>24</sup> The general exemption of the stock dividend from taxation, provided in the 1921 act,<sup>25</sup> only created more problems: dividends which *were* found to be income by the courts, using the proportionate interest test promulgated by *Eisner v. Macomber*,<sup>26</sup> got off scot free.<sup>27</sup> In 1936, Congress provided for the taxation of stock dividends which were income within the meaning of the sixteenth amendment.<sup>28</sup> This constitutional test proved unsatisfactory. Although bulwarked by the

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would be §306 stock is impossible to ascertain. Or would it all be §306 stock? This problem is nowhere considered in the Code or regulations.

<sup>23</sup> Revenue Act of 1916, ch. 463, §2(a), 39 Stat. 757. In *Towne v. Eisner*, 245 U.S. 418 (1918), an attempt by the Commissioner to tax a stock dividend had been defeated on the ground that no such tax had been imposed by the Legislature in the Revenue Act of 1913.

<sup>24</sup> *Eisner v. Macomber*, 252 U.S. 189 (1920).

<sup>25</sup> Revenue Act of 1921, ch. 136, §201(d), 42 Stat. 228.

<sup>26</sup> 252 U.S. 189 (1920). The proportionate interest test was only one of several used by the Court in the *Macomber* case to determine whether the dividend was income within the meaning of the sixteenth amendment, *viz.*, the absence of a separation of assets, as opposed to a segregation, *id.* at 204, 211-12; the fact that there was no change in the intrinsic value of shareholders certificates, *id.* at 210-11; the fact that the certificates were alike in what they represented, *id.* at 213. After vying for some time with the "receipt of something different" test [see *Frank J. & Hubert Kelly Trust*, 38 B.T.A. 1014, 1017 (1938); *John M. Keister*, 42 B.T.A. 484, 489 (1940), *rev'd sub nom.* *Sprouse v. Commissioner*, 122 F.2d 973 (9th Cir. 1941), *aff'd*, 318 U.S. 604 (1943)], the proportionate interest test was adopted as determinative. *Sprouse v. Commissioner*, 318 U.S. 604, 607 (1943).

<sup>27</sup> In *Koshland v. Helvering*, 298 U.S. 441 (1936) (common stock dividend to preferred shareholders, both classes outstanding) and *Helvering v. Gowran*, 302 U.S. 238 (1937) (preferred to common, both outstanding), the Commissioner sought to have shareholders allocate the basis of their original stock over all the shares. The Court held that since the dividends effected a change in the proportionate interest of the shareholders, the dividend, albeit exempted from taxation, was income for which shareholders had a zero basis.

<sup>28</sup> Revenue Act of 1936, ch. 690, §115(f)(1), 49 Stat. 1688. The 1934 act did not specify this constitutional test. 48 Stat. 712 (1934).

*Macomber* case on the one side and *Koshland v. Helvering*<sup>29</sup> and *Helvering v. Gowran*<sup>30</sup> on the other, there was left a vast middle ground in which the subordinate proportionate interest test was found difficult of application.<sup>31</sup> Furthermore, the decisions in *Strassburger v. Commissioner*<sup>32</sup> and *Sprouse v. Commissioner*,<sup>33</sup> which held that dividends of preferred or nonvoting common stock with respect of common stock outstanding were not "income" (there being no change in proportionate interest), opened the door to the use of such dividends to siphon off earned surplus at capital gains rates. The acme of successful "preferred stock bailouts" was reached in *Chamberlin v. Commissioner*<sup>34</sup> where, according to a prearranged plan, a preferred stock dividend was issued, immediately sold to an insurance company and redeemed by the issuing corporation. The court held that the subsequent sale and redemption, even according to a plan, could not convert the nontaxable stock dividend into a taxable dividend.

## 2. Section 305

Section 305 of the 1954 Code provides for nonrecognition of income upon the distribution of a stock dividend.<sup>35</sup> As in the case of other "nonrecognition" sections, the practical hardship of imposing a tax at a time when the taxpayer has not received the cash wherewith to pay it is taken into account. But more important, section 305 lays down the general policy of treating all stock distributions as nontaxable at the time of distribution.<sup>36</sup> On the corporate side, no reduction in earnings and profits is allowed.<sup>37</sup>

Exceptions are provided where a stock dividend is received in lieu of cash—either where the shareholder may elect to take either cash or stock<sup>38</sup> or where the dividend is distributed in discharge of preference dividends for the taxable year or for the year immediately preceding that of distribution.<sup>39</sup> These exceptions are carried over from prior statutes<sup>40</sup> and express a more general policy that where a shareholder has a right to take cash or a right to dispose of cash, the receipt of stock in lieu of cash will not convert the distribution

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<sup>29</sup> See note 27 *supra*.

<sup>30</sup> See note 27 *supra*.

<sup>31</sup> See 1 MERTENS, FEDERAL INCOME TAXATION § 9.93, at 156-58 (1956).

<sup>32</sup> 318 U.S. 604 (1943).

<sup>33</sup> *Ibid.*

<sup>34</sup> 207 F.2d 462 (6th Cir. 1953).

<sup>35</sup> CODE § 305(a).

<sup>36</sup> Rather than characterizing some as income to the extent of their fair market value as in the 1936 act. See 49 Stat. 1688 (1936).

<sup>37</sup> CODE § 312(d)(1).

<sup>38</sup> CODE § 305(b)(2).

<sup>39</sup> CODE § 305(b)(1).

<sup>40</sup> See, *e.g.*, Revenue Act of 1936, ch. 690, § 115(f)(2), 49 Stat. 1688; Revenue Act of 1939, ch. 1, § 115(f)(2), 53 Stat. 47.

into a stock dividend.<sup>41</sup> Thus, even without the application of the statute, where all shareholders endorsed dividend checks back to the corporation for stock pursuant to an agreement made prior to the distribution,<sup>42</sup> or assigned future dividends to the corporation to apply against notes given in exchange for stock,<sup>43</sup> shareholders were taxed for the receipt of a cash dividend. The receipt of stock is not determinative of the transaction.<sup>44</sup>

The Mills Committee has proposed a third exception to section 305(a).<sup>45</sup> The amendment proposes to prevent the avoidance of section 305(b)(2)<sup>46</sup> where a distribution is made with respect to common stock and such distribution is payable in stock with respect to some of the outstanding shares and in property with respect to the balance.<sup>47</sup> The effect of such a distribution would be to increase the proportionate interest of the recipient of stock in the assets and earnings and profits of the corporation.<sup>48</sup> Where there are two classes of common stock outstanding, with dividends payable in cash on one and in stock on the other and where these two classes have a reciprocal conversion feature, it is easy to see that the situation is but one step removed from the availability of an election, excepted from tax-free treatment by section 305(b)(2).<sup>49</sup> The committee justifies its denial of tax-free treatment where such a conversion feature does not exist or where there is only one class of stock, by citing the difficulty of making the applicability of the new provision dependent upon these factors; controlling shareholders could easily effect an exchange without an express conversion feature or determine the form of receipt with regard to portions of the common stock.<sup>50</sup>

By couching the amendment in terms of "change of proportionate interest," periodic stock dividends on *all* shares, with or without an accompanying cash dividend, are excluded from the operation of this exception.<sup>51</sup> While the proportionate interest test is thus reintro-

<sup>41</sup> See 1 MERTENS, FEDERAL INCOME TAXATION § 9,95, at 160-62 (1956).

<sup>42</sup> Lester Lumber Co., 14 T.C. 255 (1950); F. Brody & Sons, 11 T.C. 298 (1948).

<sup>43</sup> Charles Watson Hull, 13 B.T.A. 299 (1928).

<sup>44</sup> The *right* to elect to take cash, not its exercise, brings one within the exception of § 305(b)(2). Treas. Reg. § 1.305-2(a) (1956).

<sup>45</sup> H.R. 4459, 86th Cong., 1st Sess. § 6 (1959).

<sup>46</sup> An election to take cash or stock bars the operation of § 305(a). CODE § 305(b)(2).

<sup>47</sup> See REVISED REPORT OF ADVISORY GROUP ON SUBCHAPTER C, XLVI CCH STAND. FED. TAX REP. No. 11, at 15 (Mar. 3, 1959). [Hereinafter cited as ADVISORY GROUP REPORT.]

<sup>48</sup> H.R. 4459, 86th Cong., 1st Sess. § 6 (1959).

<sup>49</sup> See ADVISORY GROUP REPORT 15.

<sup>50</sup> *Id.* at 15-16.

<sup>51</sup> H.R. 4459, 86th Cong., 1st Sess. § 6 (1959). The Advisory Group was concerned with the possibility of the issuing corporation supporting the market for such stock and thereby participating in the conversion of the stock into cash, but declined to proffer any recommendations at this time. See ADVISORY GROUP REPORT 16.

duced into the tax law, since its area of application is clearly delimited the confusion previously associated with the test is eliminated.

The amendment appears to be an eminently practical solution to the possibility of circumventing section 305(b)(2) and the real probability of wholesale tax avoidance through the use of common stock with actual or "potential" conversion features.

### 3. Section 307

Following the distribution of a stock dividend or a stock split, the adjusted basis of the original stock must be allocated over all the stock.<sup>52</sup> Since a distribution dilutes the value of the stock, such a dilution of basis is only proper in order to reflect the new condition of the shareholder's interest.

An exception is made for stock rights distributed by a corporation where the fair market value of the rights is less than 15 per cent of the fair market value of the old stock.<sup>53</sup> In such a case, the basis of the rights will be zero unless the shareholder elects to make the allocation.<sup>54</sup> This exception is intended to limit the application of the general rule to situations involving substantial amounts of basis and to eliminate the necessity of making negligible basis computations.<sup>55</sup>

The Mills Committee has proposed a further limitation of the zero basis rule to situations where the aggregate value of the rights received does not exceed 1,000 dollars.<sup>56</sup> The Advisory Group felt that "where the amount of basis is substantial the failure to allocate basis . . . may have a substantial tax effect and may, in some cases, be subject to abuse."<sup>57</sup>

### 4. Section 306

Generally, three types of transactions give rise to section 306 stock, all of which are initially dependent upon the determination of whether the distributing corporation has earnings and profits available.<sup>58</sup> Section 306 stock is stock received as a stock dividend, other

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<sup>52</sup> CODE § 307(a).

<sup>53</sup> CODE § 307(b)(1).

<sup>54</sup> CODE § 307(b).

<sup>55</sup> See ADVISORY GROUP REPORT 21-22.

<sup>56</sup> H.R. 4459, 86th Cong., 1st Sess. § 8 (1959).

<sup>57</sup> See ADVISORY GROUP REPORT 21. "For example, a substantial amount of stock may be acquired just before a distribution of stock rights is made. The shareholder then receives the stock rights and exercises them. The distribution . . . may temporarily depress the selling price of the stock. If the zero basis rule . . . is applicable, the shareholder may be able to realize a loss on the sale of the stock with respect to which the stock rights were distributed since the basis of such stock will not have been reduced. . . ."

*Ibid.*

<sup>58</sup> CODE § 306(c)(2).

than common with respect to common, where, under section 305, no gain is recognized;<sup>59</sup> stock received in an exchange where the basis of the stock is determined with reference to the basis of section 306 stock;<sup>60</sup> and stock received in certain corporate reorganizations where no gain or loss is recognized.<sup>61</sup>

Upon the sale of section 306 stock, the amount realized is treated as ordinary income to the extent of the shares' ratable share of earnings and profits at the time of the distribution.<sup>62</sup> Upon redemption, the exchange is, in effect, disregarded, and the transaction is treated as a dividend distribution under the provisions of section 301.<sup>63</sup>

This differentiation in treatment results in totally different tax treatment to both shareholder and corporation. Since a redemption is treated as a dividend distribution, the Code follows through with complete dividend treatment, giving the shareholder the advantage of the dividend exclusion<sup>64</sup> and credit,<sup>65</sup> and permitting the corporation to reduce earnings and profits.<sup>66</sup> The computation of the ratable share of earnings and profits available is made at the end of the taxable year in which the stock was redeemed.<sup>67</sup> On the other hand, since a sale is treated as a sale of a noncapital asset,<sup>68</sup> the shareholder does not have the dividend exclusion and credit, nor may the corporation reduce earnings and profits. The stock's ratable share of earnings and profits is computed at the time of the distribution.<sup>69</sup>

In order to simplify treatment, the ALI Tax Project has recommended that all dispositions of section 306 stock be treated as redemptions under section 302, without, however, the benefit of sections 302(b)(1) and (2).<sup>70</sup> Thus, generally speaking, unless the dis-

<sup>59</sup> CODE § 306(c)(1)(A).

<sup>60</sup> CODE § 306(c)(1)(C).

<sup>61</sup> CODE § 306(c)(1)(B).

<sup>62</sup> CODE § 306(a)(1). Any excess over the amount recognized as ordinary income and the adjusted basis of the stock is capital gain. CODE § 306(a)(1)(B). Any "unused" basis is reallocated to the underlying stock. Treas. Reg. § 1.306-1(b)(2), examples (2), (3) (1955).

<sup>63</sup> CODE § 306(a)(2).

<sup>64</sup> CODE § 116.

<sup>65</sup> CODE § 34.

<sup>66</sup> CODE § 312(a).

<sup>67</sup> CODE § 316(a).

<sup>68</sup> CODE § 306(a)(1)(A).

<sup>69</sup> CODE § 306(a)(1)(A)(ii).

<sup>70</sup> ALI TAX PROJECT REPORT 79. Hence, whether the transaction is essentially equivalent to a dividend [CODE § 302(b)(1)] or is substantially disproportionate [CODE § 302(b)(2)] would be irrelevant. ALI feels that this stricter treatment is justified "... in view of the potential abuses available in the case of section 306 stock." ALI TAX PROJECT REPORT 75. However, ALI does modify its recommendations to disallow the benefit of § 302(b)(2) by providing that a disposition made by a person who, immediately after the disposition, owns less than 25% of that number of shares of common stock which he owned immediately after his receipt of the stock disposed of, will not be treated as a disposition of § 306 stock. ALI TAX PROJECT REPORT 80.

position meets the termination of interest requirement of section 302(b)(3), the transaction will be treated as a distribution of property under section 301.<sup>71</sup> In all cases, therefore, the shareholder will have the benefit of the dividend exclusion and credit.<sup>72</sup> Earnings and profits available for distribution will be computed and reduced at the end of the taxable year in which the disposition was made.<sup>73</sup>

While the ALI proposals do simplify the treatment of section 306 stock, it can be argued that ALI has adopted a different view of the nature of the bailout problem than that expressed by the Code. The recommendations seem to assume that the crux of the bailout problem is at the time at which the stock is disposed.<sup>74</sup> The Code, on the other hand, seems to take the view that the crux of the problem is at the time of distribution—the time at which the attempt to siphon off earnings and profits is made. This argument is supported by the exception stated in the definition of section 306 stock: if there are no earnings and profits at the time of distribution, no section 306 stock results.<sup>75</sup> The change of focal point to the time of disposition, as provided by the Code treatment of redemptions,<sup>76</sup> is neither anomalous nor proof of the ALI assumption, when one considers that the original parties to the bailout are again engaged in a transaction which has the same symbol of earnings as its subject matter. The exchange of the symbol for the property symbolized may be disregarded as an exchange and treated as a present distribution.

But whatever the resolution of these varying points of view, treatment which allows the dividend exclusion and credit to the shareholder and an opportunity to the corporation to reduce earnings and profits in *all* cases is desirable. If the reason for “tainting” stock with ordinary income is that in fact the stock represents latent dividend income, it seems only proper to follow through with complete dividend treatment.

Even under the present Code treatment of sales of section 306 stock, these advantages could be secured. Upon sale, the shareholder could be allowed the benefit of sections 34 and 116 to the extent that the ordinary income is received under section 306(a)(1). At the time when the corporation actually does distribute property with respect to the formerly tainted stock—that is, at such time as it may redeem this stock from the transferee—it could be allowed to reduce earnings and profits either to the extent that ordinary “dividend” income was recognized to the shareholder or to the extent that the

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<sup>71</sup> ALI TAX PROJECT REPORT 80.

<sup>72</sup> *Ibid.*

<sup>73</sup> *Id.* at 87.

<sup>74</sup> See *ibid.*

<sup>75</sup> CODE § 306(c)(2). The ALI committee admits that under its view of the problem “. . . the logic of this exception is not clear.” ALI TAX PROJECT REPORT 87.

<sup>76</sup> CODE § 306(a)(2).

corporation would otherwise be able to reduce earnings and profits under the provisions of section 312(e),<sup>77</sup> whichever is the greater. This double-barrelled measuring rod is necessary in order to secure the opportunity to reduce earnings and profits presently allowed under section 312(e) and, at the same time, allow a reduction to the extent that "dividend" income was recognized should that amount exceed the amount allowed under present law.<sup>78</sup>

Since the Mills Bill does not treat of this problem, it seems clear that the committee has rejected any change in the basic outlines of section 306(a). However, some consideration of amending section 306(a)(1) so as to allow complete dividend treatment does seem desirable.

### *Other Problems Under Present Law*

#### 1. Step Redemptions

In *Chamberlin v. Commissioner*,<sup>79</sup> a corporation declared a preferred stock dividend. Only one class of common stock was outstanding. Pursuant to a prearranged plan, shareholders sold this stock to an insurance company from which the issuing corporation subsequently redeemed pursuant to a redemption feature. The Commissioner contended that although the preferred stock was issued as a nontaxable dividend,<sup>80</sup> the plan formulated prior to the distribution coupled with the actual sale immediately after receipt constituted the proceeds of the sale a taxable dividend to the extent of available earnings. It was held that while the plan was admittedly for the purpose of siphoning off earned surplus at capital gains rates, the distribution was in substance a stock dividend and, in spite of the plan to avoid taxes, did not become a taxable cash dividend upon sale.<sup>81</sup>

Under the 1954 Code, the door opened by the *Chamberlin* decision has been largely closed by section 306 since, upon sale, ordi-

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<sup>77</sup> Amounts distributed in a redemption reduce earnings and profits, except to the extent that the amount is properly chargeable to the capital account. CODE § 312(e).

<sup>78</sup> Reducing earnings and profits at the time of the sale would be undesirable since at this time the corporation has not distributed any property. Were the transferee to hold onto his shares, subsequent property distributions by the corporation would be return of capital. CODE §§ 301(c)(1), (2), 316(a).

<sup>79</sup> 207 F.2d 462 (6th Cir. 1953).

<sup>80</sup> A preferred stock dividend with respect to common, when only common stock is outstanding, was not income under the 1939 Code. Revenue Act of 1939, ch. 1, § 115(f)(1), 53 Stat. 47; *Strassburger v. Commissioner*, 318 U.S. 604 (1943).

<sup>81</sup> The court found that the redemption feature was customary and reasonable, hence its presence did not affect the nature of the distribution. *Chamberlin v. Commissioner*, 207 F.2d 462, 471 (6th Cir. 1953).

nary income would be realized.<sup>82</sup> Yet in the case of non-section 306 stock the problem of reaping a return which is essentially a dividend thinly disguised as a capital gain by means of a step redemption may still exist. For example, a sale or gift by shareholders of a portion of their stock, either common or preferred, to a third party followed by a total redemption by the corporation from this party would very likely be accorded capital gain treatment, in spite of the fact that had shareholders redeemed directly, the redemption would, very probably, be either essentially equivalent to a dividend or pro rata or both.<sup>83</sup> Use of this method is limited, of course, by the disinclination to give voting stock to an outside party.<sup>84</sup> However, where untainted preferred stock is the subject matter of the circular transaction, the tax avoidance possibilities are limited only by the amount of outstanding preferred stock or the taxpayer's greed!<sup>85</sup>

The ALI committee has recommended that such "step redemptions" be treated as direct redemptions from the shareholders.<sup>86</sup> Since, undoubtedly, the redemption would then be either essentially equivalent to a dividend or pro rata, or both, section 301 would be applicable.<sup>87</sup> This proposal is simple, effective and practical, and considers the economic realities of such step transactions.

In spite of section 306, certain problems still exist in this area with regard to preferred stock. When earnings and profits are low, preferred stock may be issued in anticipation of increased earnings. Following the increase, this stock can be sold to a third party and redeemed pursuant to redemption features. The disposition being, in form, a sale, the shareholder's ratable share in earnings and profits is computed at the time of the distribution<sup>88</sup>—when earnings and profits were low. The economic effect of this circular transaction is to distribute the increase in earnings at capital gains rates.<sup>89</sup>

Since the ALI treats all dispositions of section 306 stock under section 302, it was unnecessary for the committee to extend its proposal concerning step redemptions to this area. Yet such an exten-

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<sup>82</sup> CODE § 306(a)(1). In fact, since the dividend exclusion and credit are unavailable, such a transaction is even less desirable.

<sup>83</sup> See ALI TAX PROJECT REPORT 82.

<sup>84</sup> It is also limited by the rules governing constructive ownership of stock. CODE § 318.

<sup>85</sup> Note that the limitation of § 302(b)(2)(D) is applicable to a series of redemptions made pursuant to a plan the effect of which is a distribution which is not substantially disproportionate, *not* to discrete sales followed by a single disproportionate redemption. See CODE § 302(b)(2)(D); Treas. Reg. §§ 1.302-3(a),(b) (1955).

<sup>86</sup> ALI TAX PROJECT REPORT 92.

<sup>87</sup> CODE §§ 302(a), (b)(1), (2).

<sup>88</sup> CODE § 306(a)(1)(A)(ii).

<sup>89</sup> Shareholders would have nothing to lose since, if the anticipated increase did not occur, a direct redemption would shift the focal point for the computation of earnings to the time of the disposition, with the benefit of §§ 34 and 116.

sion under the present Code is realistic and desirable. If such step redemptions were universally to be treated as direct redemptions, which, in substance, they are, under present law section 301 would be applicable by virtue of section 306(a)(2). Thus available earnings and profits would be computed at the time of the sale, and the avoidance through a distribution in anticipation of increased earnings would be cut off.

## 2. "Twin" Section 306 Shares

Section 306 stock is further defined as stock received in a tax-free exchange the basis of which is determined with reference to the basis of section 306 stock.<sup>90</sup> Thus, an exchange of section 306 stock for the stock of a controlled corporation, where, under section 351, no gain or loss is recognized,<sup>91</sup> would not be a disposition to which section 306(a) applies<sup>92</sup> and would result in the creation of twin section 306 shares,<sup>93</sup> since the transferee corporation receives a carry-over basis<sup>94</sup> while the transferor has a substituted basis in the new stock.<sup>95</sup> Whether or not the Legislature intended this "contagion" rather than a single "taint," such a contagion is necessary under the present Code in order to prevent tax avoidance. For example, if the transferred section 306 shares were to become "de-tainted" in the hands of the corporate transferee, a redemption by the issuing corporation of all the transferred shares (and sufficient common stock of the transferor to meet the 80 per cent requirement of section 302(b)(2)<sup>96</sup>) would result in capital gains.<sup>97</sup> A subsequent liquidation of the wholly-owned corporation would result in capital gain or loss to the transferor since redemptions in liquidation, partial or complete, are specifically excepted from section 306(a).<sup>98</sup>

At the same time, however, the creation of twin section 306 shares may result in the double taxation of the underlying "dividend" income. In order to prevent this result, and, at the same time, block other possible avenues of tax avoidance, both the ALI committee and the Mills Committee have recommended that a specific exception be carved out of section 351 for the case of an exchange of section 306 stock so that such an exchange will be recognized as a taxable

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<sup>90</sup> CODE § 306(c)(1)(C).

<sup>91</sup> CODE § 351(a).

<sup>92</sup> CODE § 306(b)(3).

<sup>93</sup> Treas. Reg. § 1.306-3(e) (1955).

<sup>94</sup> CODE § 362(a)(1).

<sup>95</sup> CODE § 358(a)(1).

<sup>96</sup> Since if 50% in value of the stock in the transferee corporation is owned by the transferor, such common stock as he owns is constructively owned by the corporation. CODE § 318(a)(2)(C)(ii).

<sup>97</sup> CODE §§ 302(a), (b)(2).

<sup>98</sup> CODE § 306(b)(2).

transfer.<sup>99</sup> The underlying dividend income would thus be taxed *once* at that time and the corporation, receiving a stepped-up basis,<sup>100</sup> would take the transferred stock "de-tainted."<sup>101</sup>

### 3. Bequests of Section 306 Stock

The estate or distributee takes the property of its decedent with a stepped-up basis,<sup>102</sup> hence any section 306 stock that the decedent might have possessed becomes "de-tainted."<sup>103</sup> By operation of section 1014, a large part of the capital gains inherent in the increased value of property escapes tax.<sup>104</sup> A bequest of section 306 stock escapes not only capital gains but inherent ordinary income. Thus by holding on to section 306 stock until death, there may be accomplished a very effective bailout of earnings and profits. Furthermore, it is hard to perceive any substantial distinction between a bequest of section 306 stock—essentially a gift of undistributed dividend income—and "income with respect of a decedent" which, under section 691, is includible in the gross income of the recipient.<sup>105</sup>

Certainly this "de-tainting" cannot be justified on the purely formal grounds that a stepped-up basis removes the taint. Moreover, to say that death terminates the interest of the decedent in the stock would be to distort this exception, ignoring the fact that there is undoubtedly a scheme for avoidance involved,<sup>106</sup> and allow a shareholder

<sup>99</sup> See ALI TAX PROJECT REPORT 85; H.R. 4459, 86th Cong., 1st Sess. § 18 (1959).

<sup>100</sup> CODE § 362(a).

<sup>101</sup> See ADVISORY GROUP REPORT 17-18.

<sup>102</sup> CODE § 1014(a).

<sup>103</sup> Treas. Reg. § 1.306-3(e) (1955). By virtue of the fact that the stock, in the hands of the beneficiary, does not have a basis determined by reference to § 306 stock. CODE §§ 1014(a), 306(c)(1)(C).

<sup>104</sup> See extract from a statement of Randolph Paul before the House Ways and Means Committee, quoted in SURREY & WARREN, FEDERAL INCOME TAXATION 623 (1955).

<sup>105</sup> CODE § 691(a)(1). "The amount of all items of gross income in respect of a decedent which are not properly includible in respect of the taxable period in which falls the date of his death . . . shall be included in the gross income, for the taxable year when received, of: (A) the estate . . . ; (B) the person who, by reason of the death . . . acquires the right to receive the amount . . . ; or (C) the person who acquires from the decedent the right to receive the amount by bequest, devise or inheritance. . . ." *Ibid.*

It is submitted further, that this "undistributed dividend income" is not dissimilar to the accrued interest on United States Savings Bonds, specifically included within the meaning of "income in respect of a decedent." Treas. Reg. § 1.691(a)-2(b), example (3) (1957).

<sup>106</sup> The basic reason behind this exception is that the shareholder could have received capital gains treatment had he sold all his common stock prior to the stock dividend. Although his investment is now divided into two stock interests, a complete termination of interest after the division should not alter the result. See SURREY & WARREN, FEDERAL INCOME TAXATION 1118

to accomplish by bequest what he could not have accomplished by inter vivos gift.<sup>107</sup>

To provide that, notwithstanding the stepped-up basis, section 306 stock would remain tainted in the hands of the recipient, would not completely solve the problem. Furthermore, if the decedent were to provide that one beneficiary was to receive all the preferred stock and another the common stock,<sup>108</sup> a redemption of all the preferred, being a complete termination of the beneficiary's interest, would be removed from the operation of section 306(a).<sup>109</sup>

On the other hand, since the amount of all items of income with respect of a decedent are taxed on receipt without exception,<sup>110</sup> to provide that section 691 should apply to amounts received upon the disposition of section 306 stock by the beneficiary to the extent that the stock was tainted would deny the advantage of the exception of complete termination of interest. Where an obvious plan for tax avoidance, such as that outlined in the preceding paragraph, is not present, *i.e.*, where the beneficiaries receive ratable shares of both common and section 306 preferred stock, this may seem like an undue hardship. However, the real possibility of widespread tax avoidance through bequests of section 306 stock clearly outweighs the speculative hardship upon the beneficiaries. Furthermore, bearing in mind that the beneficiaries have in fact received bailout income, it becomes difficult to sympathize with their complaint that they must pay the tax thereon.<sup>111</sup>

#### 4. Charitable Contributions

Under the present Code, no gain or loss is recognized upon the contribution of an appreciated capital asset to charity<sup>112</sup> and a deduction is allowed to the extent of the fair market value of the property.<sup>113</sup> There is, therefore, a decided tax benefit in contributing appreciated property. Where section 306 stock is given<sup>114</sup> there is an added

(1955). Yet a bequest, like a gift, does not, properly speaking, terminate testator's interest, but rather extends to the object of testator's bounty the opportunity of reaping the income of the decedent's initial investment.

<sup>107</sup> In the hands of the donee, the stock would be § 306 stock by virtue of § 306(c)(1)(C), since the donee takes the donor's basis. CODE § 1015(a).

<sup>108</sup> Such a disposition is frequently preferable, as where decedent wishes to leave his surviving spouse a substantial beneficial interest in his business but give the management of the business to his sons.

<sup>109</sup> CODE § 306(b)(1).

<sup>110</sup> CODE § 691(a).

<sup>111</sup> Nor should they be heard to complain that they do not have the advantage of reallocating "unused" basis to the remaining stock since, under § 1014(a), they have already received a stepped-up basis.

<sup>112</sup> See 2 CCH 1959 STAND. FED. TAX REP. ¶ 1864.432. See also SURREY & WARREN, FEDERAL INCOME TAXATION 278 (1955).

<sup>113</sup> Treas. Reg. § 1.170-1(c) (1958).

<sup>114</sup> No income is realized upon the gift of § 306 stock, and a full deduction is allowed. Rev. Rul. 328, 1957-2 CUM. BULL. 229.

benefit, since there is an element of bailout of earnings and profits, not merely a gift of unrecognized capital gain.<sup>115</sup> Clearly, if it is blessed to give appreciated property, a gift of section 306 stock is twice blessed.

In order to eliminate this problem, the ALI committee has proposed that the amount of charitable deduction be reduced by the amount that would have been a dividend.<sup>116</sup> The Advisory Group on Subchapter C has adopted the same solution.<sup>117</sup> While this solution would prevent the deduction of untaxed income, where the sum of the allowable section 306 charitable deduction plus other contributions equals or exceeds the percentage limitation upon such deductions the dividend concept would still be avoided since the taxpayer would be able to contribute tax-free income.<sup>118</sup> If, however, the amount disallowed were considered in the computation of the amount allowable within the percentage limitation, this flaw would be eliminated.<sup>119</sup> While this would result in a complete denial of any tax benefit upon the contribution of section 306 stock,<sup>120</sup> it is, again, difficult to sympathize with the taxpayer, even when he gives alms. The policy of the Code is to discourage the issue and use of the preferred stock bailout since this is a highly effective device for the avoidance of taxes. As the taxpayer is under no constraint to cause the issue or accept section 306 stock, but rather is forewarned that to do so is to place himself beneath a legal sword of Damocles, a complaint of hardship must fall upon deaf ears.

### *Some Conclusions*

1. It appears that the basic outlines of section 306(a) are not to be altered. Indeed, the change suggested by the ALI Tax Project, while tantalizing in its simplicity, involves not merely a change in treatment but possibly a change in viewpoint as to the nature of the bailout problem. The Code policy which seems to place the crux of the problem at the time of distribution is, at least, equally valid. Furthermore, the inertia which such a change must overcome is well-nigh prohibitive: the Legislature seems more concerned with the modi-

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<sup>115</sup> See ALI TAX PROJECT REPORT 95 n.8; ADVISORY GROUP REPORT 16-17.

<sup>116</sup> ALI TAX PROJECT REPORT 95 n.8.

<sup>117</sup> ADVISORY GROUP REPORT 17.

<sup>118</sup> See ALI TAX PROJECT REPORT 95 n.8.

<sup>119</sup> A taxpayer who had an income of \$100,000 and gave § 306 stock with a fair market value of \$10,000, all of which was tainted, and \$10,000 cash, would be allowed only a \$10,000 deduction. The fair market value of § 306 stock would be used as a measuring rod in determining the amount within the percentage limitation of §§ 170(b)(1)(A), (B)—\$20,000—but would be disallowed by the proposed amendment.

<sup>120</sup> In fact, it penalizes the contributor since it effects an inclusion of the amount of "taint" in gross income but does not effect any increase in the amount allowable to taxpayer within the percentage limitation.

fication and refinement of the present Code than with sweeping changes in its basic outlines. It is submitted, however, that it is desirable to give more consistent dividend treatment to sales of section 306 stock by amending section 306(a)(1) so as to allow the dividend exclusion and credit to the shareholder and afford the corporation an opportunity to reduce earnings and profits at the time when the issuing corporation redeems the former section 306 stock.

2. The possibility of tax avoidance through the use of "step redemptions" needs much attention. To treat all such redemptions as direct redemptions is not only realistic but necessary if the circumvention of sections 302(b)(1) and (2) and the accomplishment of modified preferred stock bailouts through the issue of stock dividends in anticipation of increased earnings are to be prevented.

3. Bequests of appreciated property receive highly favorable tax treatment in that the inherent capital gain escapes taxation. Yet this boon does not justify the escape of ordinary income by a bequest of section 306 stock. In the first place, the Code draws a strict line between bequests of appreciated property and income, section 1014(a) expressly granting a benefit with regard to the former, while sections 691 and 1014(c) specifically subject the latter to tax in the hands of the recipient. Secondly, the most cursory consideration indicates that bequests of appreciated property are customary, usual and not motivated by a purpose to avoid tax, whereas bequests of section 306 stock are, at first blush, rather questionable. Finally, the possibility of tax avoidance through such a bequest, especially in the case of a "family" or closely held corporation, is extreme.

As noted above, to provide that the stock should not become "de-tainted" would not completely solve the problem. Further, section 306 stock seems to be within the spirit, if not precisely within the letter, of section 691. It is submitted therefore, that section 691 be amended so as to bring section 306 stock within the purview of "income in respect of a decedent" to the extent that such stock was tainted in the hands of the decedent.

4. Charitable contributions of section 306 stock are closely related to bequests. In both areas, section 306 stock, because of its peculiar nature, has been able to creep under the beneficent wing of sections whose favors were intended for appreciated assets, not bailout income. The ferment in this area is such that it can be safely predicted that the solution proposed by both the ALI Tax Project and the Advisory Group on Subchapter C, *i.e.*, to disallow deduction of the "taint," will be adopted. The simplicity of this solution is appealing yet, as noted, not entirely complete as the donor may exceed the percentage limitation upon charitable deductions and accomplish a bailout of earnings by contributing them to charity. To pro-

vide further that the amount disallowed still be used as a measuring rod to determine the amount allowable within the percentage limitation would correct this defect yet maintain the essential simplicity of the solution.



### STATE WRONGFUL DEATH STATUTES AS APPLIED IN MARITIME ACTIONS

Recent decisions of the Supreme Court of the United States in the field of maritime law have been optimistically regarded as "... several . . . that [settle] long debated issues of admiralty law."<sup>1</sup> Whether this optimism is justified remains to be answered by future litigation. They may in fact "settle" issues, but possibly at the expense of opening many new points of debate; there is little doubt, however, that their impact will be extensively felt. This note will attempt to indicate their likely effects and will concern itself with problems arising from the practice in maritime law of "borrowing" state wrongful death statutes where death occurs on the navigable waters of a state.

A framework will first be provided within which to consider this specific problem by summarily tracing the three main concepts involved: (1) the warranty of seaworthiness; (2) persons to whom the warranty is owed; and (3) recoveries for death in admiralty. Following this will be a discussion of the *Skovgaard* and *Halecki* cases recently decided by the Supreme Court.<sup>2</sup>

In this approach there are immediate pitfalls—each of the preliminary topics, for example, is worthy of extensive individual treatment. Secondly, the topics of warranty of seaworthiness and individuals to whom it is owed are of course intertwined in their development, and separate consideration of each is attempted solely for the sake of clarity. In addition, the lengthy introductory material is presented with a view toward an understanding of each concept before engaging in the main discussion—that of their interplay in the specific death actions which are our primary interest.

#### *Introduction*

There was no recovery for wrongful death under the general maritime law.<sup>3</sup> Recovery is now authorized by several federal stat-

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<sup>1</sup> N.Y. Times, Feb. 25, 1959, p. 62, col. 5.

<sup>2</sup> United N.Y. & N.J. Sandy Hook Pilots Ass'n v. Halecki, 358 U.S. 613 (1959); The Tungus v. Skovgaard, 358 U.S. 588 (1959).

<sup>3</sup> The Harrisburg, 119 U.S. 199 (1886).