CHAPTER 6

STOCK DIVIDENDS AND SECTION 306 STOCK

A. INTRODUCTION

Code: Skim §§ 305; 306; 317(a).

It should be evident by now that Subchapter C has been the backdrop for a continuing cops and robbers saga. The goals of the robbers are clear enough, even if their methods may be a bit obscure. When they ran out of ideas to avoid the double tax, the robbers shifted their focus to bailing out corporate earnings at the least tax cost. The cops were quick to respond, but they sometimes lacked direction and even were known to engage in isolated acts of police brutality. Nowhere does this drama have a richer history than in the area of stock dividends and Section 306 stock. But for many of these skirmishes, the operative word may now be "history," at least as long as dividends and long-term capital gains are taxed at the same preferential rate.

The evolving plot is best appreciated by first putting the underlying transactions into perspective. A stock dividend is simply a distribution of stock (or rights to acquire stock)[1] by a corporation to some or all of its shareholders. If the distributed stock is of the same class as the shareholder's underlying holdings, a stock dividend is similar to what is known as a "stock split." The only difference is that a stock dividend requires the corporation to transfer an appropriate amount from retained earnings to paid-in capital while a stock split usually increases the number of outstanding shares without any adjustment to the corporate capital account.[2] A stock dividend, however, need not be of the same class of stock as the shareholder's existing interest in the corporation. Preferred stock may be distributed with respect to common or vice versa, and more complex capital structures present the opportunity for countless variations.

Stock dividends accomplish a variety of business objectives. Some public companies periodically pay small "common on common" stock dividends instead of cash ostensibly to provide their shareholders with some tangible evidence of their interest in corporate earnings while

1 I.R.C. § 305(d)(1) defines the term "stock" to include rights to acquire such stock.

2 A "reverse" stock split decreases the number of shares outstanding. Apart from the financial accounting distinctions, the line of demarcation between a stock dividend and a stock split usually is drawn by the relationship of the number of shares distributed to the previously outstanding shares. To better inform shareholders, the rules of the New York Stock Exchange provide that a distribution of less than 25 percent of the shares outstanding prior to the distribution will be a stock dividend. Larger distributions (e.g., distributions of one share for each share held) are labelled splits. New York Stock Exchange Listed Company Manual, § 703.02.

allowing the corporation to retain cash for use in the business. Although these distributions may have an incidental impact on the price of the stock, they are more of a shareholder public relations gesture than an event of any financial consequence. Stock splits often are prompted by a desire to increase the number of outstanding shares and thus reduce the price per share in an attempt to increase the marketability (and market value) of the stock on a listed exchange by making it more attractive to smaller investors.

The business objectives may be different in the case of a closely held corporation. In that setting, stock distributions frequently are a vehicle to shift corporate control.[3] To illustrate, assume that all the outstanding stock of Family Corporation is owned by Mrs. Older and has a fair market value of $1,000 per share. Mr. Younger, Older's son, has been employed by Family for several years and Older expects to gradually shift control of the business to Younger. Older's plan faces several obstacles. Gifts of Family common stock to Younger may not be desirable because Older is unwilling to part with that much wealth or the gift tax liability may be prohibitive. Younger also may not be able to afford a significant purchase of stock from his mother because the current price of Family common stock is too high.

As an alternative, Family might distribute a new class of preferred stock to Older. The preferred stock could be structured with dividend rights and a liquidation preference so that its value absorbs most of the net worth of the company, leaving the common stock with only nominal value. The distribution of preferred stock to Older will be tax-free[4] and, since the value of the common stock will be substantially reduced, Older more easily may shift control to Younger through gifts or even sales of common stock.[5]

The tax consequences of the stock distribution to Older in our example are governed by Section 305, which generally provides that gross income does not include a distribution of stock by a corporation to its shareholders with respect to its stock. This exclusion, however, is subject to various exceptions, the most important of which are found in Section 305(b). Consequently, the applicability of the Section 305(b) exceptions is the critical inquiry in analyzing the tax consequences of a stock distribution. These exceptions are examined more closely in the next section of this chapter. It is sufficient for now to note that the preferred stock distribution to Older is not a taxable stock dividend. What do you suppose is the rationale for that result?

---

[3] A recapitalization frequently is an alternative method for making adjustments to the corporation's capital structure. In certain situations, a recapitalization may provide more favorable income tax results. See Chapter 11, infra.

[4] I.R.C. § 305(a). The preferred stock, however, would be Section 306 stock assuming Family has earnings and profits. See Section C of this chapter, infra.

[5] But see I.R.C. §§ 2701 et seq., which limits the estate planning advantages of this strategy.

Lest we forget the cops and robbers saga, there is one other aspect of the previous example to consider. Recall that Older owns 100 percent of the outstanding Family common stock, and Family makes a tax-free distribution of a new class of preferred stock to Older. Assume further that Family has ample earnings and profits. If Older retained her common stock rather than giving it to her son, the preferred stock distribution historically provided her with an opportunity for tax avoidance. She could sell the preferred stock to Facilitator for cash and, after a short period of time, the corporation could redeem the preferred stock, paying Facilitator an appropriate premium for the shares. When the dust settled, this series of transactions had virtually the same economic effect as a cash distribution by Family to Older: Older has cash in hand, Family's corporate treasury has been depleted, and Older still owned 100 percent of the company. But the tax consequences appeared to be dramatically different. Rather than being stuck with a taxable dividend, Older hoped to enjoy "sale" treatment on the disposition of the preferred stock to Facilitator. A sale enabled Older to recover her basis in the preferred stock and to recognize a long-term capital gain to the extent the amount realized on the sale exceeded her basis.[6] A closer examination reveals that this potential loophole (is it still?) was closed by Section 306, which was the legislative response to Older's tax avoidance plan—the so-called "preferred stock bailout." In our simple example, the preferred stock will bear the taint of "Section 306 Stock," and Section 306(a)(1) will characterize Older's amount realized on the sale to Facilitator as ordinary (dividend?) income.[7] The last section of this chapter explores the details of Section 306 and evaluates its continuing significance.

B. TAXATION OF STOCK DIVIDENDS UNDER SECTION 305

Code: §§ 305(a)–(d); 307; 312(d)(1)(B), (f)(2); 1223(4).

Regulations: §§ 1.305–1, –2, –3(a), (b), (c), (e) Examples (1)–(4), (8), (10) & (11), –4, –5(a), –6, –7(a); 1.307–1.

The current scheme for taxing stock distributions is a distant cousin of statutes fashioned during the infancy of the income tax and is the product of a checkered legislative history. The Revenue Act of 1916 provided that a "stock dividend shall be considered income, to the amount of its cash value."[8] In 1920, the Supreme Court considered the

6 This assumes that Older had a long-term holding period in the Family common stock, which could be tacked in determining the holding period of the preferred. I.R.C. § 1223(5).

7 I.R.C. § 306(a)(1)(A), (c)(1)(A). Prior to the enactment of Section 306 as part of the 1954 Code, the Service argued that in substance these transactions were equivalent to a cash distribution. The argument met with sporadic success. Compare Chamberlin v. Commissioner, 207 F.2d 462 (1953), cert. denied, 347 U.S. 918, 74 S.Ct. 516 (1954), with Rosenberg v. Commissioner, 36 T.C. 716 (1961).

8 Revenue Act of 1916, § 2(a). In Towne v. Eisner, 245 U.S. 418, 38 S.Ct. 158 (1918), the Supreme Court concluded that a stock dividend was not "income" or "dividends" under the Revenue Act of 1913.

constitutionality of this provision in Eisner v. Macomber.[9] Mrs. Macomber, a common shareholder of a corporation with no other class of stock outstanding, received a proportionate distribution of additional common stock. The Supreme Court held that the distribution was not taxable because it did not constitute "income" within the meaning of the 16th Amendment to the Constitution. Although the Court's constitutional commentary has been discredited,[10] the result in *Macomber* is eminently logical and has been codified in Section 305(a). Whatever reshuffling may occur in the corporation's capital account, a common-on-common stock dividend does little more than crowd the shareholder's safe deposit box (or brokerage account) with additional stock certificates or book entry shares evidencing the same ownership interest held before the distribution.

An obedient Congress swiftly responded to the Supreme Court's interpretation of the 16th Amendment with a primitive declaration that stock dividends "shall not be subject to tax."[11] The stock dividend terrain remained calm until the Supreme Court generated a minor tremor in 1936 with its decision in Koshland v. Helvering.[12] Corinne Koshland, a shareholder who owned cumulative nonvoting preferred stock, received a distribution of voting common stock. She subsequently disposed of her preferred stock and asserted that she was entitled to use the stock's full cost basis in determining her gain. Since the prior common stock distribution was received tax-free, the Service contended that a proportionate amount of Mrs. Koshland's basis in her preferred shares should be allocated to the common, thereby increasing the gain on the disposition of her preferred stock. The Supreme Court agreed with the shareholder's contention and in the course of its opinion shed additional light on the meaning of Eisner v. Macomber:[13]

> Although *Eisner v. Macomber* affected only the taxation of dividends declared in the same stock as that presently held by the taxpayer, the Treasury gave the decision a broader interpretation which Congress followed in the Act of 1921. Soon after the passage of that Act, this court pointed out the distinction between a stock dividend which worked no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and such a dividend where there had either been changes of corporate identity or a change in the nature of the shares issued as dividends whereby the

---

[9] 252 U.S. 189, 40 S.Ct. 189 (1920).

[10] See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 8.40[1].

[11] Revenue Act of 1921, § 201(d).

[12] 298 U.S. 441, 56 S.Ct. 767 (1936).

[13] 298 U.S. at 445–46, 56 S.Ct. at 769–70. In Helvering v. Gowran, 302 U.S. 238, 58 S.Ct. 154 (1937), the Court held that a shareholder took a zero basis in preferred shares received as a nontaxable distribution on common stock.

proportional interest of the stockholder after the distribution was essentially different from his former interest. Nevertheless the successive statutes and Treasury regulations respecting taxation of stock dividends remained unaltered. We give great weight to an administrative interpretation long and consistently followed, particularly when the Congress, presumably with that construction in mind, has reenacted the statute without change. The question here, however, is not merely of our adopting the administrative construction but whether it should be adopted if in effect it converts an income tax into a capital levy.

We are dealing solely with an income tax act. Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old—the new certificates, plus the old, representing the same proportionate interest in the net assets of the corporation as did the old—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes.

Koshland at least educated Congress on the subtleties of taxing stock dividends, but the legislators were not yet up to the task of devising a precise statutory solution. Instead, they tossed the ball back into the judiciary's court by providing in the Revenue Act of 1936 that a distribution of stock or rights to acquire stock was not to be treated as a dividend to the extent it did "not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."[14] The Supreme Court declined the invitation to reconsider *Eisner v. Macomber,* preferring to develop a "proportionate interest test," under which a stock dividend was taxable if it increased a shareholder's proportionate interest in the corporation.[15]

It was back to the drawing board, however, with the enactment of the Internal Revenue Code of 1954. Seeking a simple approach, Congress enacted the predecessor of current Section 305, largely as an expression of dissatisfaction with the proportionate interest test. A far more elaborate system was adopted in the Tax Reform Act of 1969. The following excerpt of legislative history describes the 1954 Code provisions

---

14 Revenue Act of 1936, § 115(f)(1). This test was carried over to the 1939 Code.

15 See the legislative history in the text at p. 302, infra. See also Helvering v. Sprouse, 318 U.S. 604, 63 S.Ct. 791 (1943), where the Supreme Court decided that a pro rata distribution of nonvoting common stock to a shareholder owning voting common stock was nontaxable because it did not change the proportionate interests of the shareholders, and Strassburger v. Commissioner, 318 U.S. 604, 63 S.Ct. 791 (1943), where the Court held that a distribution of cumulative nonvoting preferred stock to the corporation's sole shareholder was not taxable because "[b]oth before and after the event he owned exactly the same interest in the net value of the corporation as before." Id. at 607, 63 S.Ct. at 792.

and explains the 1969 amendments, which added the key elements of the current version of Section 305.

Senate Finance Committee Report on Tax Reform Act of 1969

S.Rep. No. 91–552, 91st Cong., 1st Sess. 150–54 (1969).

Present law.—In its simplest form, a stock dividend is commonly thought of as a mere readjustment of the stockholder's interest, and not as income. For example, if a corporation with only common stock outstanding issues more common stock as a dividend, no basic change is made in the position of the corporation and its stockholders. No corporate assets are paid out, and the distribution merely gives each stockholder more pieces of paper to represent the same interest in the corporation.

On the other hand, stock dividends may also be used in a way that alters the interests of the stockholders. For example, if a corporation with only common stock outstanding declares a dividend payable at the election of each stockholder, either in additional common stock or in cash, the stockholder who receives a stock dividend is in the same position as if he received a taxable cash dividend and purchased additional stock with the proceeds. His interest in the corporation is increased relative to the interests of stockholders who took dividends in cash.

Present law (sec. 305(a)) provides that if a corporation pays a dividend to its shareholders in its own stock (or in rights to acquire its stock), the shareholders are not required to include the value of the dividend in income. There are two exceptions to this general rule. First, stock dividends paid in discharge of preference dividends for the current or immediately preceding taxable year are taxable. Second, a stock dividend is taxable if any shareholder may elect to receive his dividend in cash or other property instead of stock.

These provisions were enacted as part of the Internal Revenue Code of 1954. Before 1954 the taxability of stock dividends was determined under the "proportionate interest test," which developed out of a series of Supreme Court cases, beginning with Eisner v. Macomber, 252 U.S. 189 (1920) [T.D. 3010, C.B. 3, 25]. In these cases the Court held, in general, that a stock dividend was taxable if it increased any shareholder's proportionate interest in the corporation. The lower courts often had difficulty in applying the test as formulated in these cases, particularly where unusual corporate capital structures were involved.

Soon after the proportionate interest test was eliminated in the 1954 Code, corporations began to develop methods by which shareholders could, in effect, be given a choice between receiving cash dividends or increasing their proportionate interests in the corporation in much the same way as if they had received cash dividends and reinvested them in the corporation. [The report then described those methods in detail and summarized the initial response of the Treasury Department. Ed.]

* * *

On January 10, 1969, the Internal Revenue Service issued final regulations under which a number of methods of achieving the effect of a cash dividend to some shareholders and a corresponding increase in the proportionate interest of other shareholders are brought under the exceptions in section 305(b), with the result that shareholders who receive increases in proportionate interest are treated as receiving taxable distributions.

General reasons for change.—The final regulations * * * do not cover all of the arrangements by which cash dividends can be paid to some shareholders and other shareholders can be given corresponding increases in proportionate interest. * * *

Methods have also been devised to give preferred stockholders the equivalent of dividends on preferred stock which are not taxable as such under present law. For example, a corporation may issue preferred stock for $100 per share which pays no dividends, but which may be redeemed in 20 years for $200. The effect is the same as if the corporation distributed preferred stock equal to 5 percent of the original stock each year during the 20-year period in lieu of cash dividends. The committee believes that dividends paid on preferred stock should be taxed whether they are received in cash or in another form, such as stock, rights to receive stock, or rights to receive an increased amount on redemption. Moreover, the committee believes that dividends on preferred stock should be taxed to the recipients whether they are attributable to the current or immediately preceding taxable year or to earlier taxable years.

Explanation of provisions.—The bill continues (in sec. 305(b)(1)) the provision of present law that a stock dividend is taxable if it is payable at the election of any shareholder in property instead of stock.

The bill provides (in sec. 305(b)(2)) that if there is a distribution or series of distributions of stock which has the result of the receipt of cash or other property by some shareholders and an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation, the shareholders receiving stock are to be taxable (under sec. 301).

For example, if a corporation has two classes of common stock, one paying regular cash dividends and the other paying corresponding stock dividends (whether in common or preferred stock), the stock dividends are to be taxable.

On the other hand, if a corporation has a single class of common stock and a class of preferred stock which pays cash dividends and is not convertible, and it distributes a pro rata common stock dividend with respect to its common stock, the stock distribution is not taxable because the distribution does not have the result of increasing the proportionate interests of any of the stockholders.

In determining whether there is a disproportionate distribution, any security convertible into stock or any right to acquire stock is to be treated as outstanding stock. For example, if a corporation has common stock and convertible debentures outstanding, and it pays interest on the convertible debentures and stock dividends on the common stock, there is a disproportionate distribution, and the stock dividends are to be taxable (under section 301). In addition, in determining whether there is a disproportionate distribution with respect to a shareholder, each class of stock is to be considered separately.

The committee has added two provisions to the House bill (secs. 305(b)(3) and (4)) which carry out more explicitly the intention of the House with regard to distributions of common and preferred stock on common stock, and stock distributions on preferred stock. The first of these provides that if a distribution or series of distributions has the result of the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, all of the shareholders are taxable (under sec. 301) on the receipt of the stock.

The second of the provisions added by the committee (sec. 305(b)(4)) provides that distributions of stock with respect to preferred stock are taxable (under sec. 301). This provision applies to all distributions on preferred stock except increases in the conversion ratio of convertible preferred stock made solely to take account of stock dividends or stock splits with respect to the stock into which the convertible stock is convertible.

The bill provides (in section 305(b)(5)) that a distribution of convertible preferred stock is taxable (under sec. 301) unless it is established to the satisfaction of the Secretary or his delegate that it will not have the result of a disproportionate distribution described above. For example, if a corporation makes a pro rata distribution on its common stock of preferred stock convertible into common stock at a price slightly higher than the market price of the common stock on the date of distribution, and the period during which the stock must be converted is 4 months, it is likely that a distribution would have the result of a disproportionate distribution. Those stockholders who wish to increase their interests in the corporation would convert their stock into common stock at the end of the 4-month period, and those stockholders who wish to receive cash would sell their stock or have it redeemed. On the other hand, if the stock were convertible for a period of 20 years from the date of issuance, there would be a likelihood that substantially all of the stock would be converted into common stock, and there would be no change in the proportionate interest of the common shareholders.

The bill provides (in sec. 305(c)) that under regulations prescribed by the Secretary or his delegate, a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption treated as a section 301 distribution, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder is to be treated as a distribution with respect to each shareholder whose proportionate interest is thereby increased. The purpose of this provision is to give the Secretary authority to deal with transactions that have the effect of distributions, but in which stock is not actually distributed.

The proportionate interest of a shareholder can be increased not only by the payment of a stock dividend not paid to other shareholders, but by such methods as increasing the ratio at which his stock, convertible securities, or rights to stock may be converted into other stock, by decreasing the ratio at which other stock, convertible securities, or rights to stock can be converted into stock of the class he owns, or by the periodic redemption of stock owned by other shareholders. It is not clear under present law to what extent increases of this kind would be considered distributions of stock or rights to stock. In order to eliminate uncertainty, the committee has authorized the Secretary or his delegate to prescribe regulations governing the extent to which such transactions shall be treated as taxable distributions.

For example, if a corporation has a single class of common stock which pays no dividends and a class of preferred stock which pays regular cash dividends, and which is convertible into the common stock at a conversion ratio that decreases each year to adjust for the payment of the cash dividends on the preferred stock, it is anticipated that the regulations will provide in appropriate circumstances that the holders of the common stock will be treated as receiving stock in a disproportionate distribution (under sec. 305(b)(2)).

It is anticipated that the regulations will establish rules for determining when and to what extent the automatic increase in proportionate interest accruing to stockholders as a result of redemptions under periodic redemption plan are to be treated as taxable distributions. A periodic redemption plan may exist, for example, where a corporation agrees to redeem a small percentage of each common shareholder's stock annually at the election of the shareholder. The shareholders whose stock is redeemed receive cash, and the shareholders whose stock is not redeemed receive an automatic increase in their proportionate interests. However, the committee does not intend that this regulatory authority is to be used to bring isolated redemptions of stock under the disproportionate distribution rule (of sec. 305(b)(2)). For example, a 30 percent stockholder would not be treated as receiving a constructive dividend because a 70 percent stockholder causes a corporation to redeem 15 percent of its stock from him.

Revenue Ruling 78–60

1978–1 Cum. Bull. 81.

Advice has been requested whether under section 302(a) of the Internal Revenue Code of 1954 the stock redemptions described below qualified for exchange treatment, and whether under section 305(b)(2) and (c) the shareholders who experienced increases in their proportionate interests in the redeeming corporation as a result of the stock redemptions will be treated as having received distributions of property to which section 301 applies.

Corporation *Z* has only one class of stock outstanding. The *Z* common stock is held by 24 shareholders, all of whom are descendants, or spouses of descendants, of the founder of *Z*.

In 1975, when *Z* had 6,000 shares of common stock outstanding, the board of directors of *Z* adopted a plan of annual redemption to provide a means for its shareholders to sell their stock. The plan provides that *Z* will annually redeem up to 40 shares to its outstanding stock at a price established annually by the *Z* board of directors. Each shareholder of *Z* is entitled to cause *Z* to redeem two-thirds of one percent of the shareholder's stock each year. If some shareholders choose not to participate fully in the plan during any year, the other shareholders can cause *Z* to redeem more than two-thirds of one percent of their stock, up to the maximum of 40 shares.

Pursuant to the plan of annual redemption, *Z* redeemed 40 shares of its stock in 1976. Eight shareholders participated in the redemptions. The following table shows the ownership interests of the *Z* shareholders before and after the 1976 redemptions. [The table has been omitted. It shows that none of the 24 shareholders owned 13 percent or more of the corporation's stock before or after the redemption and, after the redemption, each shareholder's actual and constructive ownership was at least 97 percent of its ownership prior to the redemption. Ed.]

Issue 1

Section 302(a) of the Code provides that if a corporation redeems its stock, and if section 302(b)(1), (2) or (3) applies, the redemption will be treated as a distribution in part or full payment in exchange for the stock.

Section 302(b)(1) of the Code provides that section 302(a) will apply if the redemption is not essentially equivalent to a dividend. Section 302(b)(2) provides that section 302(a) will apply if the redemption is substantially disproportionate with respect to the shareholder unless the redemption is made pursuant to a plan the purpose or effect of which, in the aggregate, is not substantially disproportionate with respect to the shareholder. Section 302(b)(3) provides that section 302(a) will apply if all of the stock of the corporation owned by the shareholder is redeemed. Section 318(a) contains rules of constructive stock ownership to be applied to those provisions of subchapter C to which they are expressly made applicable. Section 302(c)(1) provides, with an exception not relevant here, that the constructive ownership rules of section 318(a) apply in determining the ownership of stock for purposes of section 302.

Section 302(d) of the Code provides that a stock redemption to which section 302(a) does not apply will be treated as a distribution of property to which section 301 applies.

None of the redemptions here qualified under section 302(b)(3) of the Code because all of the shareholders who participated in the redemptions continue to own stock of *Z*. Moreover, none of the redemptions qualified under section 302(b)(2) because none of the shareholders who participated in the redemptions experienced a reduction in interest of more than 20 percent, as section 302(b)(2)(C) requires. Therefore, the first question is whether the redemptions were "not essentially equivalent to a dividend" within the meaning of section 302(b)(1).

Section 1.302–2(b) of the regulations provides that the question whether a distribution in redemption of stock is not essentially equivalent to a dividend under section 302(b)(1) of the Code depends on the facts and circumstances.

In United States v. Davis, 397 U.S. 301 (1970), rehearing denied, 397 U.S. 1071 (1970), 1970–1 C.B. 62, the Supreme Court of the United States said that for a redemption to qualify as not essentially equivalent to a dividend under section 302(b)(1) of the Code, the redemption must result in a meaningful reduction of the shareholder's proportionate interest in the corporation. The Court held that the business purpose of the redemption is irrelevant to this determination and that the ownership attribution rules of section 318(a) apply.

Several of the shareholders of *Z* experienced reductions in their proportionate interests in *Z* (taking into account constructive stock ownership under section 318 of the Code) as a result of the 1976 redemptions. If their reductions were "meaningful," they are entitled to exchange treatment for their redemptions under section 302(a). Whether the reductions in proportionate interests were 'meaningful' depends on the facts and circumstances.

In this case, an important fact is that the 1976 redemptions were not isolated occurrences but were undertaken pursuant to an ongoing plan for *Z* to redeem 40 shares of its stock each year. None of the reductions in proportionate interest experienced by *Z* shareholders as a result of the 1976 redemptions was "meaningful" because the reductions were small and each shareholder has the power to recover the lost interest by electing not to participate in the redemption plan in later years.

Accordingly, none of the 1976 redemptions qualified for exchange treatment under section 302(a) of the Code. All of the redemptions are to be treated as distributions of property to which section 301 applies.

Issue 2

Section 305(b)(2) of the Code provides that section 301 will apply to a distribution by a corporation of its stock if the distribution, or a series of distributions that includes the distribution, has the result of the receipt of property by some shareholders, and increases in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation.

Section 305(c) of the Code authorizes regulations under which a redemption treated as a section 301 distribution will be treated as a section 301 distribution to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by the redemption.

Section 1.305–7(a) of the Income Tax Regulations provides that a redemption treated as a section 301 distribution will generally be treated as a distribution to which sections 305(b)(2) and 301 of the Code apply if the proportionate interest of any shareholder in the earnings and profits or assets of the corporation deemed to have made the stock distribution is increased by the redemption, and the distribution has the result described in section 305(b)(2). The distribution is to be deemed made to any shareholder whose interest in the earnings and profits or assets of the distributing corporation is increased by the redemption.

Section 1.305–3(b)(3) of the regulations provides that for a distribution of property to meet the requirements of section 305(b)(2) of the Code, the distribution must be made to a shareholder in the capacity as a shareholder and must be a distribution to which section 301 [or one of several other specified sections] applies. A distribution of property incident to an isolated redemption will not cause section 305(b)(2) to apply even though the redemption distribution is treated as a section 301 distribution.

Section 305 of the Code does not make the constructive stock ownership rules of section 318(a) applicable to its provisions.

The 16 shareholders of *Z* who did not tender any stock for redemption in 1976 experienced increases in their proportionate interests of the earnings and profits and assets of *Z* (without taking into account constructive stock ownership under section 318 of the Code) as a result of the redemptions. Shareholders *B* and *X*, who surrendered small amounts of their stock for redemption in 1976, also experienced increases in their proportionate interests. The 1976 redemptions were not isolated but were undertaken pursuant to an ongoing plan of annual stock redemptions. Finally, the 1976 redemptions are to be treated as distributions of property to which section 301 of the Code applies.

Accordingly, *B*, *X* and the 16 shareholders of *Z* who did not participate in the 1976 redemptions are deemed to have received stock distributions to which sections 305(b)(2) and 301 of the Code apply. See examples (8) and (9) of section 1.305–3(e) of the regulations for a method of computing the amounts of the deemed distributions.

NOTE

Collateral Tax Consequences. The collateral tax consequences of a stock distribution (e.g., basis, holding period, and effect on earnings and profits) depend upon whether or not the distribution is taxable to the shareholders. Taxable distributions are governed by the rules in Section 301. The amount of the distribution is the fair market value of the stock.[16] The shareholder takes a fair market value basis in the distributed stock, and his holding period runs from the date of the distribution.[17] The distributing corporation recognizes no gain or loss under Section 311(a)(1), and it may reduce its earnings and profits by the fair market value of the distributed stock.[18]

If a stock distribution is nontaxable under Section 305(a), the shareholder must allocate the basis in the stock held prior to the distribution between the old and new stock in proportion to the relative fair market values of each on the date of distribution,[19] and the holding period of the old shares may be tacked on in determining the holding period of the distributed stock.[20] The distributing corporation recognizes no gain or loss on the distribution of its stock[21], and it may not reduce its earnings and profits.[22]

Stock Rights Distributions. Section 305 also governs distributions of stock rights (sometimes called warrants). Public companies occasionally issue rights to acquire additional stock at a favorable price as a means of raising equity capital.[23] Like stock dividends generally, rights distributions are not taxable unless they come within one of the Section 305(b) exceptions.[24] In the case of a nontaxable rights distribution, Section 307(a) generally requires an allocation of basis between the underlying stock and the rights in proportion to their relative fair market values on the date of the distribution.[25] In most cases, however, such an allocation is unnecessary because of an administrative convenience exception in Section 307(b), which provides that the rights shall take a zero basis if their fair market value is less than 15 percent of the value of the stock with respect to which they were distributed. Taxpayers with time on their hands (or the incentive to make an allocation) may elect to use the allocation method prescribed in Section 307(a).[26] Taxable rights distributions are treated as Section 301 distributions; as such, their value (if any) is a dividend to the extent of the distributing corporation's earnings and profits.

---

16 Reg. § 1.305–1(b)(1). This rule also applies to corporate shareholders. Reg. § 1.301–1(d)(1)(ii). In the case of noncorporate shareholders, taxable stock dividends may be "qualified" and eligible for the preferential rates under Section 1(h)(11).

17 Reg. § 1.301–1(h).

18 Reg. § 1.312–1(d).

19 I.R.C. § 307(a); Reg. § 1.307–1.

20 I.R.C. § 1223(4).

21 I.R.C. § 311(a)(1).

22 I.R.C. § 312(d)(1)(B).

23 See, e.g., Rev. Rul. 72–71, 1972–1 C.B. 99.

24 See I.R.C. § 305(d)(1), which treats rights as "stock" for purposes of Section 305.

25 But the regulations permit this allocation only if the rights are exercised (in which event the basis allocated to the rights is added to the cost of the new stock acquired) or sold. If the rights simply lapse, the shareholder recognizes no loss but the basis returns to the underlying stock. Reg. § 1.307–1(a).

26 I.R.C. § 307(b)(2).

PROBLEMS

Frank F J A100 B50 B 50 Hill

1. Hill Corporation is organized with two classes of voting common stock: Class A and Class B. Shares in each class of stock have an equal right to Hill's assets and earnings and profits. Frank owns 100 shares of Class A stock, and Fay and Joyce each own 50 shares of Class B stock.

Assuming that Hill Corporation has ample earnings and profits, determine whether the following distributions are taxable under § 301 or excludable under § 305(a):

(a) A pro rata distribution of nonconvertible preferred stock to both classes of shareholders.

(b) A pro rata distribution of Class A stock on Class A and Class B on Class B. The Class B shareholders also are given the option to take cash in lieu of additional Class B shares. Joyce exercises this option.

(c) A pro rata distribution of Class A stock on Class A and a cash distribution on Class B.

(d) Assume that Class B is a class of nonconvertible preferred stock which pays regular cash dividends and Hill distributes Class B stock to the Class A shareholder.

(e) Same as (d), above, except that Hill distributes a class of nonconvertible preferred stock which has rights to assets and earnings and profits subordinate to those of the existing Class B stock (i.e., "junior" nonconvertible preferred stock) to the Class A shareholder.

(f) Assume that Hill has only one class of common stock outstanding and also has issued a series of 10 percent debentures convertible into common stock at the rate of one share of common stock for each $1,000 debenture. Hill makes an annual interest payment to the debenture holders and one month later distributes a "common on common" stock dividend to the common shareholders without adjusting the conversion ratio on the debentures.

(g) Same as (f), above, except that the debentures are convertible preferred stock. The corporation declares a one-for-one split on the common stock (i.e., each shareholder receives one new share of common stock for each old share) and the conversion ratio of the preferred is doubled.

(h) Assume again that Class A and Class B are both classes of voting common stock. Hill makes a pro rata distribution of Class A on Class A and a distribution of newly issued shares of nonconvertible preferred stock on Class B.

(i) Same as (h), above, except that the preferred stock which is distributed is convertible into Class B stock over 20 years at Class B's market price on the day of the distribution.

2. Z Corporation has one class of common stock outstanding held by unrelated individuals A (500 shares), B (300 shares), and C (200 shares). Will § 305(c) create any tax problems if Z agrees to redeem annually 50 shares of stock at the election of each shareholder, and A makes such an election for two consecutive years?

C. SECTION 306 STOCK

1. THE PREFERRED STOCK BAILOUT

As previewed earlier in this chapter, Section 306 is one of several provisions in Subchapter C that are much less significant as long as dividends and long-term capital gains of noncorporate taxpayers are taxed at the same preferential rates. The specific target of Section 306 was the preferred stock bailout, a device used by shareholders in the "good old days" to withdraw corporate earnings at very favorable capital gains rates. In the classic transaction, a profitable C corporation would make a tax-free distribution of preferred stock to its common shareholders, who then sold the preferred stock to an accommodating investor (often a lightly-taxed insurance company) and reported long-term capital gain on the sale. The investor collected dividends on the preferred stock and, a few years later, the corporation redeemed the preferred stock from the investor. The net effect was the receipt of cash by the shareholders on the sale of the preferred stock and, after the redemption from the investor, there would be no reduction of their proportionate interest in the corporation.

In Chamberlin v. Commissioner,[27] the Service contended that the preferred stock dividend was taxable as ordinary income on these facts. The Sixth Circuit disagreed, using language dear to the hearts of taxpayers: "[t]he general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits." The court found that the buyer of the preferred stock (the "investor") made a bona fide investment, the preferred stock dividend was legally paid, the subsequent redemption was a distribution to the investor (not the common shareholders), and nothing in the statute permitted the common shareholders' gain on the sale of the preferred stock to be taxed as ordinary income.

The *Chamberlin* case was decided under the 1939 Code. Left unchecked, the court's endorsement of the preferred stock bailout would have encouraged other closely held corporations to engage in similar profitable end runs around the distribution rules. Although the result in *Chamberlin* possibly would have been overturned in subsequent litigation, the Treasury wisely sought a prompt legislative solution. The central issue facing the drafters of the 1954 Code was whether to attack

[27] 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918, 74 S.Ct. 516 (1954).

the bailout by taxing all "preferred on common" stock dividends or to defer the punishment until the shareholder disposed of stock with bailout potential.

Common shareholders who receive a proportionate preferred stock dividend have not increased their interest in the corporation. They simply have a tax opportunity which they may choose to forego for nontax reasons. For example, there may be valid business reasons (e.g., a shift of control from older to younger generation shareholders) for a preferred stock dividend. Recognizing these and other nontax objectives served by preferred stock dividends, Congress concluded that the *receipt* of the dividend was not the appropriate occasion for punitive action.[28] Instead, it chose to label stock with bailout potential as "Section 306 stock" and to require a shareholder to report ordinary income rather than capital gain when Section 306 stock is sold or redeemed. In the case of a sale, the ordinary income amount is generally determined by the amount that would have been a dividend at the time of the stock distribution if cash rather than stock had been distributed.[29] In the case of a redemption, the ordinary income amount is determined at the time of the cash distribution.[30] Other operational and planning aspects of Section 306 are examined below.

Whenever dividends and long-term capital gains are taxed at the same low rate, the advantages to be achieved from a bailout of corporate earnings at "capital gains rates" have diminished considerably. As with redemptions and a few other classic bailout transactions to be studied later, the only remaining tax advantages to noncorporate shareholders of a sale of stock rather than a dividend are recovery of stock basis and, in special situations, the ability to offset capital gains (but not qualified dividends) with capital losses. Section 306 nonetheless remains in the Code, in an extended period of semi-hibernation until the distinction between dividends and capital gains is restored or Congress decides that Section 306 is no longer necessary.

2. THE OPERATION OF SECTION 306

a. SECTION 306 STOCK DEFINED

Code: § 306(c)–(e).

Regulations: § 1.306–3(a)–(c), (e).

The definition of Section 306 stock is consistent with the original anti-bailout objectives of the statute. The principal category is stock distributed to a shareholder as a tax-free stock dividend under Section 305(a)—other than "common on common."[31] Ordinarily, this is preferred

28 S.Rep. No. 1622, 83rd Cong., 2d Sess. 46 (1954).

29 I.R.C. § 306(a)(1).

30 I.R.C. § 306(a)(2). See Section C2b of this chapter, infra.

31 I.R.C. § 306(c)(1)(A).

stock distributed to common shareholders by a corporation with earnings and profits. As the *Chamberlin* case illustrates, preferred stock is the primary vehicle for a bailout because it can be sold without diminishing the shareholder's control or right to share in future corporate growth. "Common" stock is excepted because it lacks bailout potential; it may not be sold without diminishing the shareholder's control and interest in corporate growth.[32]

Although the Service has not defined "common stock" for Section 306 purposes, its published rulings focus on whether a sale of the stock would cause a reduction of the shareholder's equity position in the company. The fundamental inquiry is thus whether the stock has a realistic and unrestricted opportunity to participate in the growth of corporate equity.[33] If stock has either a limited right to dividends or to assets upon liquidation, it is not "common" stock for Section 306 purposes.[34] But voting common stock that is subject to the issuing corporation's first refusal right to purchase the stock at net book value whenever a shareholder wishes to make a transfer is common stock because, upon a transfer, the shareholder will part with some or all of his interest in the future growth of the corporation vis a vis other shareholders.[35]

Congress also concluded that a tax-free stock dividend issued by a corporation with no current or accumulated earnings and profits for the year of the distribution has limited bailout potential. If cash instead of stock had been distributed, the shareholder would not have realized ordinary income whenever the distributing corporation has no earnings and profits. Consequently, Section 306 stock does not include stock which would not have been treated as a dividend at the time of distribution if cash had been distributed in lieu of the stock.[36]

To prevent an easy purge of the taint, Section 306 stock includes stock with a transferred or substituted basis.[37] This category encompasses stock received as a gift which takes a Section 1015 transferred basis, or stock received in exchange for Section 306 stock in a tax-free Section 351 transaction.[38] But the exorcist prevails when stock passes from a decedent and thus qualifies for a date-of-death basis under Section 1014. In that event, the Section 306 taint is buried along with the decedent and her old basis.

An important but more specialized category is stock (which is not common stock) received in a tax-free corporate reorganization or division

[32] See Walter, " 'Preferred Stock' and 'Common Stock': The Meaning of the Terms and the Importance of the Distinction for Tax Purposes," 5 J. Corp. Tax'n 211 (1978).

[33] See, e.g., Rev. Rul. 75–222, 1975–1 C.B. 105; Rev. Rul. 79–163, 1979–1 C.B. 131.

[34] Rev. Rul. 79–163, supra note 33.

[35] Rev. Rul. 76–386, 1976–2 C.B. 95; see also Rev. Rul. 81–91, 1981–1 C.B. 123.

[36] I.R.C. § 306(c)(2).

[37] I.R.C. § 306(c)(1)(C).

[38] In this situation, the old Section 306 stock remains tainted in the hands of the corporation, and the newly issued stock, whatever its class, also is Section 306 stock by virtue of its substituted basis under Section 358. See Rev. Rul. 77–108, 1977–1 C.B. 86.

when the effect of the transaction is substantially the same as the receipt of a stock dividend or when the stock is received in exchange for Section 306 stock. For example, preferred stock received by the shareholders of the target (i.e., acquired) corporation in a tax-free merger may be a prime candidate for Section 306 classification. This aspect of Section 306 is considered in a later chapter.[39]

The final category of Section 306 stock was added by Congress to thwart the use of a holding company to bail out earnings. Assume, for example, that Schemer holds only common stock in Profitable Co. Finding that Section 306 presents a substantial roadblock to a bailout, Schemer organizes Holding Co., exchanging her Profitable common stock for newly issued Holding common and preferred stock in a tax-free Section 351 transaction. At one time, the Holding preferred stock would not have been Section 306 stock because Holding had no earnings and profits at the time of its incorporation. This offered shareholders the very bailout opportunity that Congress was trying to prevent! Schemer could sell the Holding preferred stock to an institutional investor, recovering her basis and realizing a capital gain, and the stock later could be redeemed by the corporation—all without losing any of her control or share in the growth of Profitable.

Section 306(c)(3) blocks this maneuver by characterizing the preferred stock of Holding Co. (i.e., preferred stock acquired in a Section 351 exchange) as Section 306 stock if the receipt of money instead of the stock would have been treated as a dividend to any extent. Of course, Holding Co. has no earnings and profits so that a distribution of cash would not have been a dividend. To make the statute achieve its objective, Section 306(c)(3)(A) borrows the rules of Section 304 (relating to redemptions through the use of affiliated corporations). In our example, the Holding Co. preferred would be Section 306 stock if Profitable Co. has any current or accumulated earnings and profits. This is because a cash payment by Holding Co. for the Profitable common stock would have resulted in a dividend to Schemer under Section 304(a)(1). In effect, this means that we look to the earnings and profits of the original corporation (Profitable Co.) in determining whether the receipt of cash would have been a dividend.[40]

b. DISPOSITIONS OF SECTION 306 STOCK

Code: § 306(a).

Regulations: § 1.306–1.

The tax consequences of a disposition of Section 306 stock vary depending on whether the stock is sold or redeemed. On a sale of Section 306 stock, the amount realized is treated as dividend income to the extent

---

39 See Chapter 11, infra.

40 In testing for the effect of a dividend, the Section 318 attribution rules apply without regard to the 50 percent limitation in Sections 318(a)(2)(C) and 318(a)(3)(C). I.R.C. § 306(c)(4).

of the stock's "ratable share" of the amount that would have been a dividend if the corporation had distributed cash in an amount equal to the fair market value of the stock at the time of the distribution.[41] This rule requires the shareholder to look back to the time of distribution and determine to what extent a cash distribution would have emanated from the corporation's current or accumulated earnings and profits at that time.[42] The balance, if any, of the amount realized is treated as a reduction of the basis of the Section 306 stock, and any excess is treated as gain from the sale or exchange of the stock.[43] Although the ordinary income amount is treated as a dividend received from the corporation to allow noncorporate shareholder to qualify for the preferred rates under Section 1(h), it is not clear if corporate shareholders are eligible for the Section 243 dividends received deduction, or whether the corporation is entitled to reduce its earnings and profits when Section 306 stock is sold.[44] No loss may be recognized if the shareholder's adjusted basis in the stock exceeds the amount realized, and any unrecovered basis must be allocated back to the stock with respect to which the Section 306 stock was distributed.[45]

A shareholder who receives a nontaxable stock dividend of Section 306 stock that later is redeemed by the corporation has used two steps to achieve what could have been accomplished in a single transaction: the withdrawal of cash from the corporation. To reflect that reality and treat the transactions as a single event, Section 306(a)(2) provides that the amount realized on a redemption of Section 306 stock is treated as a Section 301 distribution, taxable as a dividend (likely a qualified dividend) to the extent of the current or accumulated earnings and profits in the year of redemption.[46] The balance of the distribution, if any, is treated as a reduction of basis and then capital gain under the rules generally applicable to nonliquidating distributions.[47]

---

41 I.R.C. §§ 306(a)(1)(A), (a)(1)(D).

42 I.R.C. § 306(a)(1)(A). This provision also applies to other nonredemption "dispositions" such as certain pledges of Section 306 stock where the pledgee can only look to the stock as security (an unlikely scenario), but it does not apply to charitable contributions of Section 306 stock. Reg. § 1.306–1(b)(1); Rev. Rul. 57–328, 1957–2 C.B. 229. For charitable deduction purposes, however, a taxpayer who contributes appreciated Section 306 stock to a qualified donee must reduce the fair market value of the donated stock by the amount that would have not have been long-term capital gain if the stock had been sold rather than donated. See I.R.C. § 170(e)(1)(A); Pescosolido v. Commissioner, 91 T.C. 52 (1988).

43 I.R.C. § 306(a)(1)(B).

44 Section 306(a)(1)(D) provides that any amount treated as ordinary income on a sale of Section 306 stock shall be treated as a dividend "[f]or purposes of section 1(h)(11) and such other provisions as the Secretary shall specify * * * ." As of early 2019, the Treasury had not yet "specified" and, until it does, it appears that corporate shareholders may not claim the dividends received deduction, and no earnings and profit reduction is authorized on a sale of Section 306 stock. See Reg. § 1.312–1(e), which says there is no adjustment to the earnings and profits of the issuing corporation upon a disposition of Section 306 stock unless such disposition is a redemption.

45 I.R.C. § 306(a)(1)(C); Reg. § 1.306–1(b)(2) Example (3).

46 I.R.C. § 306(a)(2).

47 See I.R.C. § 301(c)(2), (3).

c. DISPOSITIONS EXEMPT FROM SECTION 306

Code: § 306(b).

Regulations: § 1.306–2.

Section 306 is aimed only at bailouts, and not every disposition of Section 306 stock presents that opportunity. For example, a shareholder who sells her entire interest in a corporation (including her Section 306 stock) is not withdrawing corporate earnings while preserving control. She is engaging in a transaction that easily could have qualified for capital gain treatment irrespective of any prior stock dividend. Section 306(b)(1) thus provides that the punitive general rule of Section 306(a) shall not apply to nonredemption dispositions if the shareholder completely terminates her interest in the corporation and does not dispose of the stock to a related person within the Section 318 attribution rules.[48] A similar exception is provided for redemptions of Section 306 stock that result in a complete termination of the shareholder's interest under Section 302(b)(3) or qualify as a partial liquidation under Section 302(b)(4).[49]

Other exempt dispositions include: (1) redemptions of Section 306 stock in a complete liquidation;[50] (2) dispositions that are treated as nonrecognition transactions, such as tax-free Section 351 transfers, contributions to capital and the like;[51] and (3) distributions coupled with subsequent dispositions or redemptions of Section 306 stock if the taxpayer satisfies the Service that either: (a) the distribution and subsequent disposition or redemption, or (b) in the case of a prior or simultaneous disposition of the underlying common stock, just the disposition or redemption, was not made pursuant to a plan having tax avoidance as one of its principal purposes.[52]

Although Section 306 is aimed primarily at closely held companies, the Service's hard line position is that holders of Section 306 stock issued by public companies are not automatically entitled to relief under the "no tax avoidance" exception in Section 306(b)(4).[53] The "no tax avoidance" exception is explored in the *Fireoved* case, which follows.

---

[48] For purposes of determining whether there has been a complete termination, the Section 318 attribution rules apply. I.R.C. § 306(b)(1)(A)(iii).

[49] I.R.C. § 306(b)(1)(B).

[50] I.R.C. § 306(b)(2).

[51] I.R.C. § 306(b)(3).

[52] I.R.C. § 306(b)(4).

[53] Rev. Rul. 89–63, 1989–1 C.B. 90, revoking Rev. Rul. 56–116, 1956–1 C.B. 164.

Fireoved v. United States

United States Court of Appeals, Third Circuit, 1972.
462 F.2d 1281.

■ ADAMS, CIRCUIT JUDGE.

This appeal calls into question the application of section 306 of the Internal Revenue Code of 1954 and the "first in-first out rule" to a redemption of preferred stock in a corporation by plaintiff, one of its principal shareholders. In particular we are asked to decide whether the transaction here had "as one of its principal purposes the avoidance of Federal income tax," whether a prior sale of a portion of the underlying common stock immunized a like proportion of the section 306 stock from treatment as a noncapital asset, and whether another block of the redeemed stock should be considered to represent stock not subject to section 306.

I. Factual Background

On November 24, 1948, Fireoved and Company, Inc. was incorporated for the purpose of printing and selling business forms. At their first meeting, the incorporators elected Eugene Fireoved, his wife, Marie, the plaintiffs, and a nephew, Robert L. Fireoved, as directors of the corporation. Subsequently, the directors elected Eugene Fireoved as President and Treasurer and Marie Fireoved as Secretary. The corporation had authorized capital stock of 500 shares of $100 par value non-voting, non-cumulative preferred stock and 100 shares of $1 par value voting common stock. On December 31, 1948, in consideration for $100 cash, the corporation issued Eugene Fireoved 100 shares of common stock; for $500 cash, it issued him five shares of preferred stock; and in payment for automotive equipment and furniture and fixtures, valued at $6,000, it issued him an additional 60 shares of preferred stock.

In 1954, when Mr. Fireoved learned that his nephew, Robert, was planning to leave the business, he began discussions with Karl Edelmayer and Kenneth Craver concerning the possibility of combining his business with their partnership, Girard Business Forms, that had been printing and selling business forms for some time prior to 1954. Messrs. Fireoved, Edelmayer and Craver agreed that voting control of the new enterprise should be divided equally among the three of them. Because Mr. Fireoved's contribution to capital would be approximately $60,000 whereas the partnership could contribute only $30,000, it was decided that preferred stock should be issued to Mr. Fireoved to compensate for the disparity. In furtherance of this plan, the directors and shareholders of Fireoved and Company, in late 1954 and early 1955, held several meetings at which the following corporate changes were accomplished: The name of the company was changed to Girard Business Forms; the authorized common stock was increased from 100 to 300 shares and the authorized preferred stock was increased to 1000 shares; Mr. Fireoved exchanged his 100 shares of common and 65 shares of preferred stock for equal amounts of the new stock; an agreement of purchase was authorized by which the company would buy all the assets of the Edelmayer-Craver partnership in return for 200 shares of common and 298 shares of preferred stock; and Mr. Fireoved was issued 535 shares of the new preferred stock as a dividend[6] on his 100 shares of common stock, thereby bringing his total holding of preferred stock to 600 shares to indicate his $60,000 capital contribution compared to the $29,800 contributed by the former partnership.

As the business progressed, Mr. Edelmayer demanded more control of the company. In response, Mr. Fireoved and Mr. Craver each sold 24 shares of common stock in the corporation to him on February 28, 1958.

On April 30, 1959, the company redeemed 451 of Mr. Fireoved's 600 shares of preferred stock at $105 per share, resulting in net proceeds to him of $47,355.[7] The gain from this transaction was reported by Mr. and Mrs. Fireoved on their joint return for the year 1959 as a long term capital gain. Subsequently, the Commissioner of Internal Revenue (Commissioner) assessed a deficiency against the Fireoveds of $15,337.13 based on the Commissioner's view that the proceeds from the redemption of the 451 shares of preferred stock should have been reported as ordinary income and the tax paid at that rate based on section 306. Mr. and Mrs. Fireoved paid the assessment on March 14, 1963, but on March 10, 1965, filed a claim for a refund with the Commissioner.

After the Commissioner disallowed the refund claim on March 8, 1966, the Fireoveds instituted the present action against the United States on August 4, 1967 seeking a refund of the $15,337.13 plus interest on the ground that the transaction came within an exception to section 306, and that they were therefore entitled to report the income as a long term capital gain. The case was tried to the court without a jury on stipulated facts. It is from the district court's determination, 318 F.Supp. 133, on October 29, 1970, that $8,885.50 should be refunded to the taxpayers that both parties appeal.

II. Background of Section 306

Because we are the first court of appeals asked to decide questions of law pursuant to section 306, it is appropriate that we first examine the circumstances that led to the inclusion in 1954 of this section in the Code.

Generally, a taxpayer will benefit monetarily if he is able to report income as a long term capital gain rather than as ordinary income. Under normal circumstances a cash dividend from a corporation constitutes ordinary income to the shareholder receiving such money. Therefore, it would be to the advantage of a shareholder if a method could be devised by which the money could be distributed to him, that would otherwise be

---

[6] At the time Mr. Fireoved received his stock dividend, the company had accumulated earnings and profits of $52,993.06.

[7] In 1959, the company had accumulated earnings and profits of $48,235.

paid out as cash dividends, in a form that would permit the shareholder to report such income as a long term capital gain.

A temporarily successful plan for converting ordinary income to long term capital gain is described by the facts of Chamberlin v. C.I.R., 207 F.2d 462 (6th Cir.1953). * * *

The legislative reaction to the Chamberlin decision was almost immediate, resulting in the addition of section 306 to the 1954 Code, in order to prevent shareholders from obtaining the tax advantage of such bail-outs when such shareholders retain their ownership interests in the company.

* * *

Based on the history of section 306 and its plain meaning evidenced by the provisions, it is not disputed that the 535 shares of preferred stock issued to Mr. Fireoved as a stock dividend in 1954 were section 306 stock. Additionally, it is clear that in 1959, when the company redeemed 451 shares of Mr. Fireoved's preferred stock, the general provisions of section 306 aside from the exceptions—would require that any amount realized by Mr. Fireoved be taxed at ordinary income rates rather than long term capital gain rates, because the company had earnings at that time of $48,235 more than the $47,355 required to redeem the stock at $105 per share.

Thus, the questions to be decided on this appeal are (1) whether certain of the exceptions to section 306 apply to permit the Fireoveds' reporting their gain as a long term capital gain, and (2) whether 65 of the 451 shares redeemed are not section 306 stock because of the first in-first out rule of Treasury Regulation § 1.1012–1(c) [the court's analysis and holding on the second issue has been omitted. Ed.].

III. Was the distribution of the stock dividend "in pursuance of a plan having as one of its principal purposes avoidance of Federal income tax?"

Mr. Fireoved asserts that the entire transaction should fall within the exception established by section 306(b)(4)(A), which provides: "If it is established to the satisfaction of the Secretary or his delegate * * * that the distribution, and the disposition or redemption * * * was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax," then the general rule of section 306(a) will not apply.

As a threshold point on this issue, the Government maintains that because Mr. Fireoved never attempted to obtain a ruling from the "Secretary or his delegate" the redemption should be covered by section 306(a), and the district court should not have reached the question whether the exception applied to Mr. Fireoved. Mr. Fireoved urges that the district court had the power to consider the matter de novo, even without a request by the taxpayer to the Secretary or his delegate. Because the ultimate result we reach would not be altered by whichever of these two courses we choose, we do not resolve this potentially complex procedural problem.[10]

The district court, based on the assumption that it had the power to decide the question, found that although one of the purposes involved in the issuance of the preferred stock dividend may have been business related, another principal purpose was the avoidance of Federal income tax.

Mr. Fireoved's analysis of the facts presented in the stipulations would reach the conclusion that the sole purpose of the stock dividend was business related. He relies heavily on that portion of the stipulation which describes why the decision was made to combine his business with the Edelmayer-Craver partnership: "The partnership could provide the additional manpower which the expected departure of Robert L. Fireoved from the Corporation would require. Additionally, the partnership needed additional working capital which the Corporation had and could provide." Based primarily on the latter sentence, Mr. Fireoved asserts that the district court had no choice but to find that the transaction was business related and that it therefore had no avoidance incentive.

In making this argument, however, Mr. Fireoved overlooks the plain import of the language of section 306(b)(4). Whether the section requires the decision to be made by the Secretary or the district court, it is clear that "one of [the] principal purposes" of the stock dividend was not for "the avoidance of Federal income tax." The stipulation demonstrates no more than that the reorganized company required more capital than could be supplied by the partnership alone. The stipulation is completely in harmony with the following fact situation: After the partnership was combined with the corporation, the business required the $30,000 contributed by the partnership and all of the $60,000 Mr. Fireoved had in the corporation. Mr. Fireoved decided to take the stock dividend rather than to distribute the cash to himself as a dividend, and then to make a loan to the corporation of the necessary money because if he took the cash, he would subject himself to taxation at ordinary income rates. Therefore "one of the principal purposes" of the stock dividend would be for "the avoidance of Federal income tax."

In a situation such as the one presented in this case, where the facts necessary to determine the motives for the issuance of a stock dividend are peculiarly within the control of the taxpayer, it is reasonable to require the taxpayer to come forward with the facts that would relieve him of his liability. Here the stipulation was equivocal in determining the purpose of the dividend and is quite compatible with the thought that "one of the principal purposes" was motivated by "tax avoidance." We

---

[10] For the same reason, we do not decide this issue in Part II, infra.

hold then that the district court did not err in refusing to apply the exception created by section 306(b)(4)(A).[11]

IV. Did the prior sale by Mr. Fireoved of 24% of his underlying common stock immunize such portion of the section 306 stock he redeemed in 1959?

The district court construed section 306(b)(4)(B) to mean that any time a taxpayer in Mr. Fireoved's position sells any portion of his underlying common stock and later sells or redeems his section 306 stock, an equivalent proportion of the section 306 stock redeemed will not be subject to the provisions of section 306(a). The Government has appealed from this portion of the district court's order and urges that we reverse it, based on the history and purpose of section 306 and the particular facts here.

The stipulations indicate that, "On February 28, 1958, Fireoved and Craver each sold 24 shares of common stock in the corporation to Edelmayer," and that appropriate stock certificates were issued. From this fact, Mr. Fireoved reasons that his sale of 24 of his 100 shares of common stock was undertaken solely for the business purpose of satisfying Mr. Edelmayer's desire for more control of the corporation, and therefore he should be given the benefit of section 306(b)(4)(B). In addition, Mr. Fireoved contends that the disposition of his section 306 stock was related to a business purpose because he used part of the proceeds to pay off a $20,000 loan that the company had made to him.

Mr. Fireoved has the same burden here of showing a lack of a tax avoidance purpose that he had in section III supra. It is clear from the limited facts set forth in the stipulations that he has not established that the disposition of 24% of the 535 shares of the section 306 preferred stock he owned "was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax."[12] More important, however, is that an examination of the relevant legislative history

11 It is important to note that apparently both Mr. Fireoved, in prosecuting this action for a refund, and the Government, in its defense, assumed that if the distribution and redemption of the preferred stock were not controlled by § 306(a), the gain would be subject to taxation as a long term capital gain. This is not necessarily the case at all. Whether or not § 306 governs the transaction, it nonetheless involves a redemption of stock by a corporation to which § 302 could apply. Under the tests set out in § 302(b)—the relevant one of which appears to be § 302(b)(1)—Mr. Fireoved, who had the burden of proof, may well have been unable to show that the redemption was not "essentially equivalent to a dividend." United States v. Davis, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970). We hold, however, that it is now too late for the Government to raise this issue.

12 Consistent with Mr. Fireoved's sale of 24 shares of common stock in 1958 could have been his knowledge that one year later he would be selling his section 306 stock and a desire on his part to avoid taxation at ordinary income rates. As noted later in the opinion, the sale of just 24 shares was enough so that he retained effective control—in the form of veto power—over the corporation. Moreover, the fact that Mr. Fireoved needed $20,000 of the proceeds to pay off a loan to the corporation would not meet his burden. The proceeds of the redemption totaled $47,355. Thus, although $20,000 of the redemption may not have been to avoid taxes, we can ascribe no purpose other than tax avoidance to the receipt of the additional $27,355. Therefore, since one of the principal purposes of the redemption of 451 shares of preferred stock was "the avoidance of Federal income tax," Mr. Fireoved may not take advantage of § 306(b)(4)(B) for any part of the redemption.

indicates that Congress did not intend to give capital gains treatment to a portion of the preferred stock redeemed on the facts presented here.

It is apparent from the reaction evinced by Congress to the Chamberlin case, supra, that by enacting section 306 Congress was particularly concerned with the tax advantages available to persons who controlled corporations and who could, without sacrificing their control, convert ordinary income to long term capital gains by the device of the preferred stock bail-out. The illustration given in the Senate Report which accompanied section 306(b)(4)(B) is helpful in determining the sort of transactions meant to be exempted by section 306(a):

> Thus if a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a tax avoidance disposition since he has previously parted with the stock which allows him to participate in the ownership of the business. However, variations of the above example may give rise to tax avoidance possibilities which are not within the exception of subparagraph (B). Thus if a corporation has only one class of common stock outstanding and it issues stock under circumstances that characterize it as section 306 stock, a subsequent issue of a different Class of common having greater voting rights than the original common will not permit a simultaneous disposition of the section 306 stock together with the original common to escape the rules of subsection (a) of section 306.

Thus, it is reasonable to assume that Congress realized the general lack of a tax avoidance purpose when a person sells all of his control in a corporation and then either simultaneously or subsequently disposes of his section 306 stock. However, when only a portion of the underlying common stock is sold, and the taxpayer retains essentially all the control he had previously, it would be unrealistic to conclude that Congress meant to give that taxpayer the advantage of section 306(b)(4)(B) when he ultimately sells his section 306 stock. Cf. United States v. Davis, 397 U.S. 301, 90 S.Ct. 1041, 25 L.Ed.2d 323 (1970).

Shortly after Fireoved's corporation had been combined with the Edelmayer-Craver partnership, significant changes to the by-laws were made. The by-laws provided that corporate action could be taken only with the unanimous consent of all the directors. In addition, the by-laws provided that they could be amended either by a vote of 76% of the outstanding common shares or a unanimous vote of the directors. When the businesses were combined in late 1954, each of the directors held ⅓ of the voting stock, thereby necessitating a unanimous vote for amendment to the by-laws. After Messrs. Fireoved and Craver each sold 24 shares of common stock to Mr. Edelmayer, Mr. Fireoved held 25⅓% of the common (voting) stock, Mr. Craver 25⅓% and Mr. Edelmayer 49⅓%. It is crucial to note that the by-laws provided for a unanimous vote for corporate action, and after the common stock transfer, the by-laws were capable of amendment only by a unanimous vote because no two shareholders could vote more than 74⅔% of the common stock and 76% of the common stock was necessary for amendment. Thus, although Mr. Fireoved did sell a portion of his voting stock prior to his disposition of the section 306 stock, he retained as much control in the corporation following the sale of his common stock as he had prior to the sale. Under these circumstances it is not consonant with the history of the legislation to conclude that Congress intended such a sale of underlying common stock to exempt the proceeds of the disposition of section 306 stock from treatment as ordinary income. Accordingly, the district court erred when it held that any of the preferred shares Mr. Fireoved redeemed were not subject to section 306(a) by virtue of section 306(b)(4)(B).[14]

* * *

PROBLEMS

Preferred on common

1. In year one, Argonaut Corporation distributed nonconvertible nonvoting preferred stock worth $1,000 to each of its two unrelated equal common shareholders, Jason and Vera. The Argonaut common stock owned by each of the shareholders had a basis of $2,000 prior to the distribution and a value of $3,000 immediately after the distribution. At the time of the distribution, Argonaut had $2,000 of earnings and profits. In year three, Argonaut had $3,000 of earnings and profits.

   (a) What are the tax consequences to Jason, Vera and Argonaut of the distribution of preferred stock in year one? to 301

   (b) What results to Vera and Argonaut if Vera sells her preferred stock to Carl, an unrelated party, for $1,000 in year three? → AR = 1,000

   (c) Same as (b), above, except that Vera sells her preferred stock to Carl for $1,750? → AR = 1,750

   (d) Same as (b), above, except that Argonaut had no earnings and profits at the time of the distribution of the preferred stock?

   (e) What results if Jason gives his preferred stock to his grandson, Claude, and Claude later sells the stock for $1,000? What if Jason dies and bequeaths his preferred stock to Claude?

   (f) What result if Jason contributes his preferred stock to a public charity?

   (g) What results to Jason and Argonaut if in year three the corporation redeems half of Jason's common stock for $5,000 and all of his preferred stock for $1,500?

14 It is important to note that our decision relates only to the facts of this case. We express no view on the situation in which less than all the voting shares are sold but enough are disposed of to relinquish effective control prior to or simultaneous with the sale of section 306 stock.

(h) Same as (g), above, except the corporate bylaws require unanimous shareholder agreement for corporate action, and the bylaws may be amended only with the concurrence of more than 75 percent of the shareholders.

(i) Same as (g), above, except that Argonaut has no accumulated or current earnings and profits in year three.

2. Zapco Corporation has 100 shares of common stock outstanding all of which are owned by Sam Shifty. Zapco has an ample supply of current and accumulated earnings and profits.

(a) If Sam forms Holding Co. by transferring 50 Zapco shares in exchange for 100 shares of Holding common stock and 100 shares of Holding preferred stock, will any of the Holding shares be Section 306 stock?

(b) What result if Zapco were owned equally (50 shares each) by Sam Shifty and Selma Zap, who is unrelated to Sam, and the two shareholders form Holding Co. by transferring all their Zapco stock with Sam taking back 100 shares of Holding Co. common stock and Selma taking back 50 shares of Holding Co. preferred stock and 50 shares of Holding Co. common stock?