Federal Taxation-Reorganizations-Distribution of Boot to Shareholders of Merged Corporation Taxable as Dividend, Not Capital Gain-Shimberg v. United States

Follow this and additional works at: https://digitalcommons.law.byu.edu/lawreview

Part of the Business Organizations Law Commons, and the Taxation-Federal Commons

Recommended Citation


Available at: https://digitalcommons.law.byu.edu/lawreview/vol1978/iss4/3

This Casenote is brought to you for free and open access by the Brigham Young University Law Review at BYU Law Digital Commons. It has been accepted for inclusion in BYU Law Review by an authorized editor of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.

Mandell Shimberg, Jr., was the majority shareholder of LaMonte-Shimberg Corporation (LSC), a Florida corporation involved in home construction and sales. Shimberg, president and chief executive officer of LSC, owned 66.8% of the LSC stock. MGIC Investment Corporation (MGIC) is a Delaware corporation many times the size of LSC, engaged primarily in the financial guaranty business. In 1970 MGIC and LSC executed an agreement to merge LSC into MGIC in a transaction qualifying for statutory merger treatment under I.R.C. § 368(a)(1)(A).

In accordance with the merger agreement, Shimberg exchanged all his LSC stock for cash in the amount of $417,449, plus 21,461 shares of MGIC common stock outright, with an additional 21,461 shares placed in escrow to be delivered in five years upon satisfactory completion of the contract conditions. Shimberg and his wife jointly reported the cash distribution in connection with the merger as long term capital gain. Upon audit the IRS determined the cash payment was a dividend and was thus taxable as ordinary income. Accordingly, Shimberg paid a tax deficiency in the amount of $125,883, with interest totaling $16,170. Denial of Shimberg’s request for refund prompted the filing of this suit against the government. The district court held the transaction’s net effect was a sale and the cash received was taxable as a capital gain. The Fifth Circuit Court of Appeals

---

1. Shimberg’s wife owned an additional 1.6% of the LSC stock for the benefit of their children, while the remainder of the stock was owned by 19 unrelated shareholders.


3. LSC shareholders received pro rata a total of $625,000 in cash, 32,132 shares of MGIC common stock outright, and another 32,132 shares were placed in escrow for possible future distribution to the LSC stockholders in accordance with a formula based upon a five-year average of the LSC earnings for the years 1970 through 1974. Prior to the satisfaction of the earnings requirement and the distribution of the escrowed shares, the LSC stockholders had no rights with respect to said shares. Brief for Appellee at 5, Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), cert. denied, 47 U.S.L.W. 3476 (U.S. Jan. 16, 1979).

reversed and held the cash payment had the effect of a dividend distribution5 within the meaning of section 356(a).

I. BACKGROUND

Shareholders participating in corporate reorganizations defined in section 368(a)(1) are afforded favorable tax treatment under section 354. Section 354(a)(1) provides that no gain or loss will be recognized in reorganizations in which stock is exchanged solely for stock either (1) in the same corporation or (2) in another corporation that is a party to the reorganization. If, however, a shareholder receives money or other property (commonly called "boot") in an exchange to which section 354 would otherwise apply, section 356(a)(1) requires that any gain to the recipient be recognized to the extent of the money and the fair market value of any property received.

Whether the boot is taxed as capital gain from the sale of a capital asset or as ordinary income resulting from dividends depends on whether the exchange has the "effect of the distribution of a dividend" within the meaning of section 356(a)(2). If the boot has the effect of a dividend distribution, each distributee must treat as a dividend the amount by which his gain recognized under section 356(a)(1) does not exceed his ratable share of the undistributed earnings and profits of the corporation. The remainder, if any, of the recognized gain will be taxed as capital gain from the exchange of property.6 If the payment of boot is not considered to have the effect of a dividend, all recognized gain will receive capital gain treatment.7

A. Dividend Equivalency Principles of Section 302

The phrase "has the effect of the distribution of a dividend" in section 356(a)(2) is held to be in pari materia with the phrase "essentially equivalent to a dividend" as used in section 302(a)(1) relating to distributions in stock redemptions.8 Thus, courts have been willing to apply the principles of dividend equivalency developed under section 302 to reorganizations involving boot under

The Internal Revenue Service has also taken the position that "in appropriate cases the tests contained in that section [302] may serve as useful guidelines for purposes of applying section 356(a)(2)."\(^9\)

Section 302 provides that a distribution made in a stock redemption will be treated as a capital gain from an exchange for stock if the redemption satisfies the requirements of section 302(b)(1), 302(b)(2), or 302(b)(3).\(^11\) Otherwise the redemption is deemed a dividend, not an exchange, and is included in the ordinary income of the shareholder to the extent provided in section 301.

A shareholder who is unable to qualify for capital gains under the objective standards of section 302(b)(2) or 302(b)(3) must seek relief under section 302(b)(1), which applies a subjective test of whether or not the redemption is essentially equivalent to a dividend. The section 302(b)(1) test for dividend equivalency was established by the Supreme Court in *United States v. Davis*.\(^12\) The Court held that a distribution made in redemption of stock is not essentially equivalent to a dividend if the exchange results in a "meaningful reduction of the shareholder's proportionate interest in the corporation."\(^13\) Where, as determined from the facts and circumstances surrounding the exchange,\(^14\) the distribution does amount to a meaningful reduction, the distribution is considered an exchange for property and is treated as a capital gain.

In an effort to identify meaningful reductions in shareholders' proportionate interests in a corporation, the courts and the Service have considered three factors: (1) the right to vote and thereby exercise control, (2) the right to participate in current earnings and accumulated surplus, and (3) the right to share in the net assets on liquidation.\(^15\) "A redemption which reduces

---

11. Congress created a statutory safe harbor for capital gain treatment in § 302(b)(2)-(3). A stock redemption qualifies for capital gain treatment under the "substantially disproportionate" test of paragraph (2) if both (a) the shareholder's postredemption interest in the corporation is less than 80% of his preredemption interest and (b) the shareholder owns less than 50% of the corporation's voting power after the redemption. Section 302(b)(3) allows capital gain treatment when the corporation redeems all the shareholder's stock in the corporation.
13. Id. at 313.
these rights may result in a meaningful reduction . . . within the meaning of Davis and, thus, qualify . . . as not essentially equivalent to a dividend under section 302(b)(1) of the Code.\textsuperscript{16} The value of this analysis is questionable since these three shareholder rights are reduced in every redemption that does not involve a pro rata distribution. This analysis does not measure the amount by which stock ownership rights are reduced nor does it provide any standard for a minimum "meaningful reduction." Thus, even the reduction of all three of these rights does not guarantee capital gain status since the reduction may still not be meaningful.

The term "meaningful reduction" continues to be elusive because no per se rule defines the minimum percentage reduction of ownership required to assure that a redemption does not have the effect of a dividend.\textsuperscript{17} In one extreme situation a taxpayer was found to have experienced a meaningful reduction in interest even though his stock ownership only declined from 27% to 22.3%. The Service ruled that the taxpayer suffered a reduction in his right to vote, share earnings and profits, and share in net assets on liquidation. In addition, the taxpayer was no longer able to control the corporation in concert with another shareholder and, therefore, was entitled to capital gain treatment.\textsuperscript{18} It seems clear, however, that the Commissioner will not find a meaningful reduction in interest if the shareholder owns more than 50% of the corporate voting power immediately after the transaction.\textsuperscript{19}

\textbf{B. Section 302 Principles Applied to Section 356}

Even though the courts generally agree that the dividend equivalency principles of section 302 provide a useful guideline for the application of section 356,\textsuperscript{20} these principles are difficult to apply in the reorganization setting. To determine whether a stockholder's interest has been meaningfully reduced by a redemption transaction under section 302, the stockholder's postredemption ownership interest is compared with his preredemption interest in the same corporation.\textsuperscript{21} The meaningful reduction

\begin{footnotes}
\item[16] Id.
\item[17] Wright v. United States, 482 F.2d 600, 610 (8th Cir. 1973).
\end{footnotes}
analysis is more complex, however, in a merger-reorganization because two or more corporations are involved. Specifically, in mergers involving boot distributions authorities differ as to whether the acquired corporation or the acquiring corporation is considered to redeem the stock and distribute the boot. The question is, therefore, whether the meaningful reduction analysis is to be applied to the shareholder's interest in the acquired corporation or in the acquiring corporation.

In *Wright v. United States* the Eighth Circuit treated the boot distribution accompanying a reorganization as having been made by the acquiring corporation. The court in essence considered all the stock of the acquired corporations to be transferred to the acquiring corporation, after which a portion of the exchanged stock was redeemed for cash. The meaningful reduction test was applied in *Wright* by comparing the shareholder's interest in the acquiring corporation immediately before and after the distribution of boot. In other words, the *Wright* court compared what would have been the shareholder's stock interest in the acquiring corporation if the merger had been only a stock-for-stock exchange, with the shareholder's actual interest in the acquiring corporation following the distribution of boot.

In Revenue Ruling 75-83 the IRS contends that in reorganizations governed by section 356 the acquired corporation must be viewed as having made the redemption and distribution. The Service insists that section 302(b)(1) is to be applied to section 356 by hypothesizing a redemption by the acquired corporation immediately prior to the reorganization. The IRS therefore applies the meaningful reduction test by comparing the shareholder's interest in the acquiring corporation before and after the redemption.

The conflict between the viewpoints of the Eighth Circuit and the IRS is crucial, particularly if, as in *Shimberg*, the redemption involves a pro rata distribution of boot. Under the IRS approach, every distribution made substantially in proportion to the shareholders' stock ownership in the acquired corporation is denied capital gain treatment because there is no meaningful reduction in each shareholder's proportionate interest. The

23. 482 F.2d 600 (8th Cir. 1973).
24. *Id.* at 607.
25. *Id.*
27. "The hallmarks of a dividend, then, are pro rata distribution of earnings and profits and no change in basic shareholder relationships." Himmel v. Commissioner, 338
Wright approach does not preclude capital gain treatment per se under these circumstances because the meaningful reduction is applied in the acquiring corporation context. Since the distribution is made only to those who were shareholders of the acquired corporation, all others owning stock in the acquiring corporation prior to the merger do not participate in the boot distribution. Therefore, the distribution is not pro rata and is not necessarily considered a dividend.

II. Instant Case

In Shimberg the Court of Appeals for the Fifth Circuit rejected the district court finding that the distribution did not have the effect of a dividend distribution under section 356(a)(2).28 But in so ruling the court did not adopt in its entirety the IRS approach of Revenue Ruling 75-83 nor did it follow the Wright approach. The circuit court concluded the district court erred when it applied the meaningful reduction test of section 302 to the section 356 distribution in Shimberg.29 It observed that Shimberg's control declined from 66% stock ownership in LSC to less than 1% ownership in MGIC. Speaking for the court, Judge Thornberry stated that because the control of small corporation shareholders will always decline substantially when their corporation is swallowed by a large unrelated one, application of the meaningful reduction test in that situation would render section 356(a)(2) meaningless. Capital gains would be allowed in every case where the small corporation shareholder's control is diluted by merger with a large corporation. Therefore, according to the court, Shimberg was not an appropriate case for application of section 302 principles.30

The court distinguished Wright on three grounds: (1) two corporations of similar size merged into a new corporation in Wright while Shimberg involved a merger of two different corporations of different sizes, (2) the merging corporations in Wright were commonly owned as opposed to no common ownership in Shimberg, and (3) Wright consisted of a single boot distribution to one shareholder versus a pro rata distribution to numerous shareholders in Shimberg.31

F.2d 815, 817 (2d Cir. 1964) (emphasis in original). Given the IRS point of view, a pro rata distribution will always be treated as a dividend.
29. Id. at 288.
30. Id.
31. Id. at 287.
In place of the meaningful reduction test of section 302(b)(1), the circuit court analyzed the facts and circumstances surrounding the cash distribution to determine whether it had the effect of a dividend. The court reasoned that because a dividend is "a pro rata distribution of profits from a continuing corporation . . . and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,'" a pro rata distribution of boot to a corporation participating in a merger has the effect of a dividend distribution.32 If $625,000 cash were distributed to the shareholders prior to, or in the absence of, a corporate reorganization it would have been taxed as a dividend. Likewise, the court concluded, this distribution should be treated as a dividend.33

The Shimberg court denied its decision contravened the step transaction doctrine.34 It asserted that if the doctrine were applied to defeat the approach taken in Shimberg "it would be impossible to determine whether the 'boot' distribution had the effect of the distribution of a dividend."35 The court further argued that the boot distribution in Shimberg had not been treated as a separate step.36

III. Analysis

The Fifth Circuit’s reluctance to apply the meaningful reduction test in Shimberg can best be explained by concluding the court misunderstood the test as applied in Wright. Having considered Shimberg’s decline in stock ownership from 66% in LSC to less than 1% in MGIC, the court concluded the meaningful reduction test was inappropriate where a small corporation merges with a large corporation. The shareholders of the small corporation invariably suffer a meaningful reduction in interest under the meaningful reduction test as applied in this set of cir-

32. Id. at 288 (citing Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949)).
33. Id. at 289.
34. Tax analysis normally requires that a business transaction be separated into segments for examination. However, unfairness may result if the transaction is divided into too many parts. The step transaction doctrine has been developed to avoid injustice by preventing an integrated transaction from being broken into steps or, alternatively, by requiring that separate steps be considered together for tax purposes. Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179 (1942); Gregory v. Helvering, 293 U.S. 465 (1935); Kanawha Gas & Utils. Co. v. Commissioner, 214 F.2d 685 (5th Cir. 1954). "[A]ll parts of a multi-step exchange or reorganization are grouped together to determine the appropriate tax treatment for the entire transaction, if the several steps are an essential and integral part of the overall plan." Shimberg v. United States, 577 F.2d at 289.
35. Shimberg v. United States, 577 F.2d at 290.
36. Id.
Unfortunately, this conclusion is the product of a misinterpretation of the meaningful reduction test applied in *Wright*.

### A. Wright Approach Applied to Shimberg

The *Wright* approach to the meaningful reduction test presumes an "all stock" merger followed by a postclosing redemption of the number of shares equivalent to the boot actually distributed. Therefore, under the *Wright* approach, Shimberg's interest in MGIC—had he only received MGIC stock in exchange for his LSC stock—would be compared with his actual interest in MGIC after the redemption to determine whether his interest had been meaningfully reduced. Shimberg would have owned 0.458% of the MGIC stock outstanding if he had received all stock and no boot. In actuality, following the boot payment Shimberg was left

---

37. Acceptance of the *Wright* method as understood by the Fifth Circuit would establish a rule having the opposite effect of the now defunct "automatic dividend" rule. In *Shimberg* the Fifth Circuit denied that its decision revived the automatic dividend rule adhered to by the IRS for many years. Based on loose language in the Supreme Court's opinion in Commissioner v. Estate of Bedford, 325 U.S. 283 (1945), the automatic dividend rule meant that whenever both stock and boot were received in a distribution, all boot was taxed as dividend to the extent of the stockholder's share in the corporation's earnings and profits. The rule was finally abandoned in 1974 when the standards of dividend equivalence of § 302(b) were adopted by the IRS as useful guidelines for applying § 356. Rev. Rul. 74-516, 1974-2 C.B. 121; Rev. Rul. 74-515, 1974-2 C.B. 118. The circuit court believed a contrary decision in *Shimberg* would have the opposite effect of allowing capital gains in every merger between corporations of disproportionate size. 577 F.2d at 290.

38. Shimberg himself led the Fifth Circuit astray by promulgating this misinterpretation. The attorneys for Shimberg placed great emphasis on language in *Wright* indicating the Eighth Circuit looked at the whole of the transaction to determine dividend equivalence under § 302(b)(1) and *Davis*. Brief for Appellee at 21, 22, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 47 U.S.L.W. 3476 (U.S. Jan. 16, 1979). Consequently, they argued in *Shimberg* that the taxpayer’s 66% stock interest in LSC should be compared with his less than 1% interest in MGIC. *Id.* at 12. However, the better reading of *Wright* indicates that, although the court also considered the transaction as a realistic whole, it placed greater weight on analyzing the change in the taxpayer’s interest in the acquiring corporation. Specifically, the *Wright* court considered the decline in ownership interest in the acquiring corporation to be from 85% to 61.7%. The Eighth Circuit concluded that this 23.3% reduction in interest was meaningful. *Wright v. United States*, 482 F.2d at 609-10.

39. The merger agreement called for a total exchange of MGIC voting common stock valued at $3,750,000 and cash amounting to $625,000 for all of the outstanding shares of LSC. The market value of a share of MGIC stock at the time of the merger was $58.35. Brief for Appellee at 24 n.9, *Shimberg v. United States*, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 47 U.S.L.W. 3476 (U.S. Jan. 16, 1979). At the time of the merger, Shimberg received, in exchange for his LSC stock, 21,461 shares of MGIC stock and $417,449 in cash. Shimberg had no interest at the time of the merger in an additional 21,461 shares placed in escrow, such interest being entirely a future interest dependent on the postmerger earnings of the LSC business. Assuming that Shimberg's cash consideration had been
with only 0.344% of the stock outstanding.48 Properly applied, the Wright method shows the boot distribution to have reduced Shimberg’s interest from 0.458% to 0.344% instead of from 66% to 1% as erroneously derived by the court in Shimberg. Had the Fifth Circuit correctly applied the section 302 principles adopted in Wright, the court could have found that the boot distribution in Shimberg did cause a meaningful reduction; therefore it did not have the effect of a dividend and was a capital gain.49

received in stock, he would have obtained an additional 7,154 shares of MGIC stock ($417,449 ÷ $58.35) for a total of 28,615 (21,461 plus 7,154) shares.

Prior to the merger, 6,204,448 shares of MGIC stock were issued and outstanding. An additional 32,132 shares were issued to the LSC stockholders at the time of the merger, for a total of 6,236,580 shares issued and outstanding. Had the $625,000 cash consideration been exchanged as stock in the merger, 10,711 more shares would have been issued to the LSC stockholders ($625,000 ÷ $58.35) for a total of 6,247,291 MGIC shares issued and outstanding.

The calculations demonstrating Shimberg’s percentage of ownership follow.

Shimberg’s Percentage Ownership After the Merger:

\[
\text{MGIC shares owned by Shimberg} \quad \frac{28,615}{6,247,291} \quad \text{equivalent to cash} = 0.458\% \\
\text{issued and outstanding MGIC} \quad \text{stock (6,236,580) plus 10,711} \\
\text{shares equivalent to cash}
\]

See id.

40. Shimberg’s Percentage Ownership After the Merger and After a Redemption of His Stock Equivalent to Cash Received in the Merger:

\[
\text{MGIC shares owned by Shimberg} \quad \frac{21,461}{6,236,580} \quad \text{less 7,154 shares} \\
\text{equivalent to cash} = 0.3441\% \\
\text{issued and outstanding MGIC} \quad \text{stock (6,247,291) less 10,711} \\
\text{shares equivalent to cash}
\]

See id.

41. The decline of Shimberg’s stock ownership from 0.458% to 0.344% represents a 25% reduction and would most likely qualify Shimberg for capital gain treatment under the § 302(b)(1) meaningful reduction test. See also Rev. Rul. 76-385, 1976-2 C.B. 92 (shareholder allowed capital gain treatment when his percentage of stock ownership was reduced from 0.0001118% to 0.0001081%).

Alternatively, Shimberg could be found to qualify for capital gains through the § 302(b)(2) substantially disproportionate redemption test. Although no court has ever applied § 302(b)(2) to § 356, it appears the Eighth Circuit would have applied it had the taxpayer in Wright qualified. Wright v. United States, 482 F.2d at 608. If § 302(b)(2) is considered to be a specific example of § 302(b)(1), then paragraph (2) can be deemed applicable to § 356 since paragraph (1) is pari materia with § 356. Hawkinson v. Commissioner, 235 F.2d 747, 754 (2d Cir. 1956); Ross v. United States, 173 F. Supp. 793, 797 (Ct. Cl.), cert. denied, 361 U.S. 875 (1954).
B. IRS Approach Applied to Shimberg

Although the Fifth Circuit rejected the Wright approach, it did not directly adopt the method advanced by the IRS in Revenue Ruling 75-83. Under the IRS approach the section 302(b)(1) meaningful reduction test would be applied to compare Shimberg’s interest in the acquired corporation (LSC) prior to the merger with his interest in LSC as though LSC paid the boot in redemption of the stock before effecting the merger with MGIC. Since the boot distribution was pro rata to all the shareholders in LSC, Shimberg’s proportionate interest in LSC remained constant at 66% even though the number of shares he owned was reduced. The IRS would assert that Shimberg’s interest was not meaningfully reduced within the meaning of Davis; therefore, he

Assuming an “all stock” merger and a postclosing redemption of the number of Shimberg’s shares equivalent to the cash he actually received, all as contemplated by Wright, Shimberg suffered a substantially disproportionate redemption within the meaning of § 302(b)(2). A redemption is substantially disproportionate if (a) the shareholder’s postredemption interest in the corporation is less than 80% of his preredemption interest and (b) the shareholder owns less than 50% of the corporation’s voting power after the redemption. Calculations can demonstrate the satisfaction of § 302(b)(2):

(a) Shimberg’s Percentage Ownership After the Merger:

\[
\frac{28,615}{6,247,291} = 0.458\%
\]

(b) Shimberg’s Percentage Ownership After the Merger and After a Redemption of His Stock Equivalent to Cash:

\[
\frac{21,461}{6,236,580} = 0.3441\%
\]

(c) 80% of Shimberg’s Ownership Position Prior to the Redemption (0.458%):

\[
0.80 \times 0.00458 = 0.3666\%
\]

(d) Shimberg’s subsequent ownership position (0.3441%) is less than 0.366% (80% of his prior ownership position) and, furthermore, is less than 50% of MGIC’s total voting power.

(e) Thus, § 302(b)(2) is satisfied.


42. 1975-1 C.B. 112.
should be taxed as receiving ordinary income because the distribution was essentially equivalent to a dividend.

C. Shimberg Test for Dividend Equivalency

Instead of applying the meaningful reduction test in Shimberg, the Fifth Circuit analyzed the effect of the boot to determine whether the distribution should be deemed to have the effect of a dividend. As described above, the court concluded that under the Shimberg facts section 356(a)(2) requires a determination whether the distribution would have been taxed as a dividend if made prior to, or in the absence of, a reorganization. The Fifth Circuit has, unwittingly perhaps, adopted the bottom line of Revenue Ruling 75-83. Determination of the tax consequences of a distribution without regard to the reorganization is the same as analyzing a boot distribution in which the acquired corporation is presumed to have redeemed the stock and distributed the boot. Although the Fifth Circuit appears to apply a new test, the circuit court has actually employed the meaningful reduction test as interpreted by the IRS.

The test for dividend equivalency applied by Shimberg and Revenue Ruling 75-83 distorts reality. The test ignores the fact the reorganization is part of the transaction and absent the reorganization the distribution would in all likelihood not have been made. Furthermore, the fact the acquiring corporation generally provides the cash for boot distributions requires that the role of the acquiring corporation be considered in the tax analysis. Even if the acquired corporation possessed the necessary funds to redeem the stock, it would probably retain the funds as working capital were it not for the merger.

Although the Fifth Circuit expressly denied it, the court's disregard of the reorganization in its analysis of whether the distribution would have been taxed as a dividend violates the step transaction doctrine. That doctrine precludes the court from viewing Shimberg as a constructive redemption by the acquired company (LSC) followed by an entirely separate reorganization. By separating the hypothetical redemption from the reorganization, the court ignores both the acquiring corporation and the transaction's overall result. The court hinted its rejection of the

43. 577 F.2d at 288-89.
44. As of the time of the merger, LSC had cash of approximately $147,000. Brief for Appellee at 31 n.14, Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), cert. denied, 47 U.S.L.W. 3476 (U.S. Jan. 16, 1979).
45. The Wright method at least considers the continuity of shareholder interest from
step transaction argument stems from the close relationship the argument bears to the premise that the meaningful reduction test is appropriate in Shimberg.\textsuperscript{46} Having rejected the meaningful reduction test without understanding it, the court uses that erroneously based determination to deny application of step transaction principles.

The unfairness of the Shimberg decision can be illustrated by hypothesizing a merger in which no boot is paid, but later (sufficiently distant to avoid the effects of the step transaction doctrine) the acquiring corporation meaningfully reduces the proportionate interests of the shareholders of the acquired corporation by redeeming a portion of their stock. The Shimberg taxpayer whose receipt of boot is a part of the reorganization is found to have realized ordinary income, while the taxpayer in the delayed redemption escapes with capital gain.

IV. CONCLUSION

In deciding Shimberg, the Fifth Circuit has created a split in the circuits. Unfortunately the court thought the meaningful reduction test as applied in Wright would have created an “automatic capital gain” rule for mergers of small corporations into large corporations. As a result the real merits of that test, as applied to the facts of the instant case, were never considered. Consequently the Shimberg court generally rejected the Wright approach to determining dividend equivalency and unwittingly gave support to the IRS position in Revenue Ruling 75-83.

The Shimberg decision lends credence to the IRS' position that any pro rata distribution of boot incident to a reorganization automatically has the effect of the distribution of a dividend.\textsuperscript{47} Because the Shimberg decision does not follow Wright, nor convincingly distinguish or refute it, the result in Shimberg is wholly unsatisfactory. Instead of shedding greater light on the conflicts surrounding the interrelationship of sections 302 and 356, the Fifth Circuit has only succeeded in adding to the confusion.

Bruce E. Babcock

---

the acquired corporation to the acquiring corporation by treating the latter entity as making the distribution. Wright v. United States, 482 F.2d 600 (8th Cir. 1973).

\textsuperscript{46} 577 F.2d at 290.

\textsuperscript{47} This results in a partial revival of the “automatic dividend” rule referred to in note 37 supra.