BYU Law Review

Volume 2015 | Issue 2 Article 7

March 2015

Finishing the Job on Section 356(a)(2): Closing Loopholes and Providing Consistent Treatment to Boot in Tax-Free Reorganizations

Trevor Crowley

Finishing the Job on Section 356(a)(2): Closing Loopholes and Providing Consistent Treatment to Boot in Tax-Free Reorganizations

INTRODUCTION

The Obama administration has recently taken aim at a provision in the tax code that allows shareholders to repatriate offshore earnings from corporations without ever paying U.S. taxes on the money earned. This loophole, called the "boot-within-gain limitation," is one of several problems in section 356(a)(2) of the Internal Revenue Code.

This loophole works when a shareholder in the United States—let's say the shareholder is a corporation itself—owns two foreign corporations with earnings that have not been taxed in the United States. The shareholder causes the foreign corporations to merge in a tax-free reorganization. The shareholder structures the transaction so that the acquiring corporation gives its own stock and cash to the shareholder in exchange for all of the shareholder's stock in the target corporation. The shareholder takes care to ensure that the cash and stock received from the acquiring corporation do not exceed the value of the target corporation's stock. If the shareholder is successful, section 356(a)(2)[1] allows the shareholder to receive the cash without being taxed[2]—but for this provision, the cash would have finally been subject to U.S. federal income tax.[3] This loophole also applies when the parties to the reorganization are domestic corporations.

Tax-free reorganizations allow corporations to merge or be acquired by other corporations without being taxed on gain realized in the transaction. To qualify for tax-free treatment, the transaction has to meet specific requirements. The general requirement is that the shareholders of the target corporation must receive stock in the acquiring corporation as consideration in the transaction. The rationale for not taxing these transactions is that the shareholders are not

1. Unless otherwise specified, all references in this Comment to a "section" refer to a section within Title 26 of the United States Code.

2. 26 U.S.C. § 356(a)(2) (2012).

3. Subject to the section 902 foreign tax credit for domestic corporations. *See* Rev. Rul. 74-387, 1974-2 C.B. 207 (section 356(a)(2) boot dividends qualify for section 902).

"cashing out" their interests in the corporation; instead they are continuing their interest in another form. But section 356(a)(2) allows shareholders to do just that—cash out their interest in the corporation.

Generally, if a shareholder receives cash in a reorganization, the shareholder is taxed on the cash but can defer tax on the stock received.[4] But when the cash has the effect of a dividend, section 356(a)(2) limits the amount of cash that is taxed to the overall gain realized in the transaction.[5] In other words, if the total consideration received in a qualifying reorganization provides a ten-dollar profit to the shareholder, but the shareholder receives fifty dollars in cash, only ten dollars of that cash is subject to tax. Thus, parties can receive cash and avoid paying taxes by throwing some cash, which would otherwise be taxed as a dividend, into a reorganization. But when does cash have the effect of a dividend? Congress has not provided an answer to this question.

This is not the only problem with section 356(a)(2); it contains further opportunities for tax avoidance, it is inconsistent with the rest of the Internal Revenue Code, and it is full of uncertainties that have existed for ninety years without resolution.

Because of these shortcomings, section 356(a)(2) has been attacked by Congress on-and-off over the last sixty years[6] and the Obama administration has renewed its focus on this provision for 2016.[7] This Comment discusses the Obama administration's proposals for section 356(a)(2) and provides further recommendations for those proposals. I argue that Congress should specify when boot has the effect of a dividend and should supplant the current *Clark* rule that has developed in the courts. The replacement test should compare the shareholder's interest in the target corporation before the reorganization with the shareholder's interest in the acquiring corporation after the reorganization to determine whether there has been a meaningful reduction in interest under section 302(b).

4. *See* 26 U.S.C. § 356(a) (2012).

5. *Id.* § 356(a)(2).

6. *See, e.g.*, Robert A. King, *The Tax Treatment of Boot Distributions in Corporate Reorganizations under § 356(a)(2)*—Commissioner v. Clark, *the Latest Word?*, 11 WHITTIER L. REV. 723, 724–31 (1990).

7. *See* Treasury, General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals at 119–21 (Feb. 2015), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2016.pdf [hereinafter 2016 Revenue Proposals].

Part I of this Comment describes the policy, operation, and tax consequences of tax-free reorganizations. Part II presents a detailed analysis of section 356(a)(2) and its shortcomings. Lastly, Part III explains the Obama proposals and a fairly recent proposal from the House of Representatives and builds on these proposals to offer solutions to the problems in section 356(a)(2).

I. TAX-FREE REORGANIZATION—GENERALLY

A transaction qualifies as a tax-free reorganization if it fits within one of the seven categories described in section 368. This Part gives a brief overview of tax-free reorganizations by first discussing the policy behind tax-free reorganizations, second describing the different categories of reorganizations, and then discussing the tax consequences of a qualifying reorganization.

A. The Policy of Reorganizations

The Treasury regulations state that the purpose behind giving tax-free treatment to transactions that qualify as reorganizations is that the transactions are only "readjustments of corporate structures . . . as [ ] required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms."[8] In other words, the transaction is not an actual "sale" of the corporation, but a "mere change in form."

There are several policies behind not taxing these "changes in form." First, Congress wants to encourage efficient reorganizations that are helpful to businesses and the economy.[9] Second, the gains in a reorganization are only paper gains; the shareholders' money is still locked up in the corporation and shareholders might not be able to pay the tax.[10] Third, there is no "basic change in relationships" between the corporation and shareholders and there is "not a

8. Treas. Reg. § 1.368-1(b)(as amended in 2011).

9. S. REP. NO. 66-398, at 17–19 (1924); *see also* 61 CONG. REC. 6563 (1921) (statement of Sen. Watson) ("It is the exchange of the stock of different corporations for business purposes; and at a time when so much reorganizations going on in the business world, it is thought by all those interested in the upbuilding of the industries of the country at this time that this is a very helpful provision.").

10. S. REP. NO. 65-617, at 5-6 (1918) ("A provision was inserted designed to establish the rule for determining taxable gains in the case of exchanges of property and to negative the assertion of tax in the case of certain purely paper transactions."); *see also* S. REP. NO. 68-398, at 18 (1924).

sufficient 'cashing out' of proprietary interests" to constitute an actual realization event.[11]

With the flexibility the Treasury Department, Congress, and the courts have given to reorganizations over the years, some commentators question whether these policies are still relevant or whether reorganizations have "become a pure tax shelter shrouded in an incredibly complex statutory scheme" that "is not grounded in any overriding public policy."[12] Nevertheless, the overarching policy that reorganizations are "mere changes in form," which are not, in substance, realization events, continues to guide the requirements for reorganizations.

B. Reorganization Transactions

There are seven categories of transactions that qualify as tax-free reorganizations. Each category contains specific requirements that must be met for the transaction to qualify.[13] There are several generally applicable requirements that apply to (almost) all of the categories.

1. Generally applicable requirements

Tax-free reorganizations have been part of the Internal Revenue Code since 1918.[14] The judicial refinements that have developed over the years are now incorporated into the Treasury Regulations. The regulations set minimum requirements applicable for all seven categories of reorganizations unless an explicit exception applies: 1) continuity of shareholder interest; 2) continuity of business

11. King Enters., Inc. v. United States, 418 F.2d 511, 515 (Ct. Cl. 1969).

12. Everett Skillman, *The Non-Recognition of Taxable Gain in Corporate Reorganizations—Reassessing Legislative Policy*, 20 SW. U. L. REV. 369, 370 (1991); *see also* King, *supra* note 6, at 755–56.

13. Note that the regulations state that each transaction must be evaluated under the step-transaction doctrine. Treas. Reg. § 1.368-1(a). The step-transaction doctrine may cause a transaction—standing by itself—to be treated as a mere step in an overall transaction, rather than as an independent transaction, if the transaction is part of an overall transaction. Comm'r v. Clark, 489 U.S. 726, 738 (1989) ("[I]nterrelated yet formally distinct steps in an integrated transaction may not be considered independently of the overall transaction. By thus linking together all interdependent steps with legal or business significance, rather than taking them in isolation, federal tax liability may be based on a realistic view of the entire transaction."). Thus, an exchange qualifying as a tax-free reorganization by itself might not be given tax-free treatment if it is part of a multistep transaction that would not qualify when viewed as a whole. *See*, *e.g.*, Rev. Rul. 2008-25, 2008-1 C.B. 986.

14. Revenue Act of 1918, § 202(b), 40 Stat. 1057 (1918), *reprinted in* J. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1861-1938, at 898 (1938).

enterprise; and 3) business purpose.[15] These are only *minimum* requirements; a reorganization category itself may set out additional or stricter requirements.

The first requirement, continuity of shareholder interest, is central to the underlying policy of tax-free reorganizations; namely, shareholders should not be taxed on the transaction because the exchange is only a change in the form of the shareholder's interest in the business.[16] Essentially, it requires the acquiring corporation to furnish its *own* stock as consideration to the selling shareholders.[17] The regulations suggest that the requirement will be satisfied if at least forty percent of the consideration paid in the exchange is in stock of the acquiring corporation.[18] After the reorganization, the shareholders who received the acquiring corporation's stock are free to dispose of the stock at any time as long as it is not to a corporation related[19] to the issuing corporation.[20]

The second requirement, continuity of business enterprise, also relates to the rationale that reorganizations are simply

15. Treas. Reg. § 1.368-1(b) (as amended in 2011). As discussed above, these minimum requirements, applicable to all categories of tax-free reorganizations, may be superseded by the provisions relating to the categories themselves. As an example, continuity of interest and continuity of business enterprise are not required in connection with recapitalizations under section 368(a)(1)(E).

16. *See supra* Part II.A; *see also* H.R. REP. NO. 73-704, at 13 (1934), *reprinted* in 1939-1 C.B. (Part 2) 554, 564; BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 500 (2d ed. 1966); PAUL R. MCDANIEL, ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS 539 (3d ed. 2006).

17. Treas. Reg. § 1.368-1(e)(1)(i). For an expansive treatment on the origin and development of the continuity of interest requirement, see David. F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Reorganizations*, 17 VA. TAX REV. 419, 427 (1998) ("The new regulations shift the focus from whether Seller intended to retain a proprietary interest in the reorganized enterprise, to whether a proprietary interest was furnished by . . . the acquiring corporation."). Note that if the reorganization is structured as a triangular merger, the parent corporation of the acquiring corporation is required to furnish its stock as consideration in the exchange. *See* Treas. Reg. § 1.368-1(b).

18. Treas. Reg. § 1.368-1(e)(2)(v), ex. 1 (stating that continuity of interest requirement is met when shareholder receives $60 in cash and $40 in stock of the acquiring corporation); *see also* John A. Nelson Corp. v. Helvering, 296 U.S. 374 (1935) (holding that shareholder receipt of consideration consisting of 38% of acquiring corporation equity qualified as a tax-free reorganization treatment).

19. *See* Treas. Reg. § 1.368-1(e)(4) (as amended in 2011). The focus is on corporate shareholders. Thus, a sale to a human shareholder who owns shares of the acquiring corporation will not violate this rule. T.D. 8760, 63 Fed. Reg. 4174, 4176 (Jan. 28, 1998).

20. Treas. Reg. § 1.368-1(e)(1)(i) ("[A] mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related . . . to the issuing corporation is disregarded."); *see also id.* § 1.368-1(e)(8), ex. 3.

"readjustments of continuing interests in property under modified corporate form."[21] This requirement is met if the acquiring corporation either 1) continues one line of the target corporation's historic business, or 2) uses a significant portion of the target corporation's assets in a business.[22] This requirement is relatively easy to meet.[23] The business purpose requirement simply requires that the transaction "have a business purpose apart from tax avoidance; that is, it must be undertaken for reasons germane to the continuance of the business of a corporation."[24] Under this requirement, taxpayers are not disqualified when minimizing taxes is simply a motive of the transaction. But taxpayers are disqualified if the transaction is entered into with the main purpose of avoiding taxes.[25] The business purpose requirement, developed through case law,[26] is not explicitly stated in the regulations; however, this requirement is widely considered[27] to be implied in several places throughout the regulations.[28]

21. *Id.* § 1.368-1(d)(1).

22. *Id.* § 1.368-1(d)(1), (2).

23. For example, if the target corporation had several lines of business, the acquiring corporation is only required to continue one of the significant lines of business. *Id.* § 1.368-1(d)(2)(ii), (d)(5), ex. 1. Or if a manufacturing corporation acquires a corporation that makes components used in the manufacturing corporation's product and the acquiring corporation only keeps the assets of the target corporation as a backup in case other components from other suppliers are in short supply, the continuity of interest requirement will be satisfied. *Id.* at ex. 2.

24. Joseph R. Gomez, *Tax Aspects of Mergers and Acquisitions for the Corporate Lawyer*, 5 J. SMALL & EMERGING BUS. L. 321, 340–41 (2001).

25. To illustrate: in an early case, a sole-shareholder attempted to transfer appreciated property from the corporation to herself through a tax-free reorganization which would transfer the property to a new corporation that would then be liquidated. Gregory v. Helvering, 293 U.S. 465 (1935). Out of this case came the famous quote by Judge Learned Hand that "[a]ny one may so arrange his affairs that his taxes shall be as low as possible; . . . there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). But the Court held that, in this case, the transaction had no business purpose and was done solely for tax avoidance reasons. *Gregory*, 293 U.S. at 469.

26. *See, e.g.*, *Gregory*, 293 U.S. 465.

27. *See, e.g.*, GOMEZ, *supra* note 24; David F. Shores, *Continuity of Business Enterprise: A Concept Whose Time Has Passed*, 63 TAX L. 471, 496 (2010); Arturo Requenez II & Joshua D. Odintz, *New Flexibility Under Final Regs. Affecting Foreign-Law Mergers and Section 367*, 105 J. TAX'N, 151 (Sept. 2006).

28. Treas. Reg. § 1.368-2(b)(2)(as amended in 2010) parenthetically states that "business purpose" is one of the general requirements of a reorganization. For other provisions where the business purpose requirement is implied, see Treas. Reg. § 1.368-1(b) ("The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures . . . as are required by business exigencies . . . . Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the

2. Categories of reorganization

The seven categories of reorganizations in § 368(a)(1)(A)–(G) have unique and specific requirements. The categories are often referred to in shorthand by reference to the appropriate subparagraph—for example, a reorganization structured pursuant to § 368(a)(1)(A) is referred to as a "Type A" reorganization.

Type A, B, and C reorganizations are the "acquisitive" reorganizations. These transactions involve one corporation acquiring another corporation. Type A reorganizations are "statutory mergers."[29] These are mergers affected pursuant to state corporate law. After a Type A reorganization is complete, the acquiring corporation will own all assets and liabilities of the target corporation, and the target corporation will cease to exist.[30]Type A reorganizations are frequently used in triangular reorganizations where the target corporation merges into a subsidiary of the acquiring corporation.[31] As a result, the acquiring corporation is able to shield itself from any liabilities assumed from the target corporation while taking advantage of the flexibility of Type A reorganizations.[32]

Type B reorganizations are "stock for stock acquisitions" where the selling shareholders exchange their stock for stock of the

benefit of the exception from the general rule."); and Treas. Reg. § 1.368-2(g) ("[T]he readjustments involved in the exchanges . . . must be undertaken for reasons germane to the continuance of the business . . . .").

29. 26 U.S.C. § 368(a)(1)(A) (2012).

30. Treas. Reg. § 1.368-2(b)(1)(ii); *see also* Rev. Rul. 2000-5, 2000-1 C.B. 436. There are no further specific requirements for Type A reorganizations; however, Type A reorganizations are subject to the generally applicable requirements discussed above. Thus, shareholders of the target corporation may receive as much as 60% of the consideration in the form of boot and as little as 40% of the consideration in the form of acquiring corporation stock. Treas. Reg. § 1.368-1(e)(2)(v), ex. 1; *see also supra* Part I.B.1.

31. *See* Treas. Reg. § 1.368-2(b)(1)(iii), ex. 4. This type of reorganization is authorized by § 368(a)(2)(D). Certain additional requirements apply to such a transaction; namely, substantially all of the target corporation's assets must be acquired, and no stock of the subsidiary corporation may be used in the transaction. Thus, the stock must come from the parent corporation. *Id*. The "substantially all" requirement is the same as the "substantially all" requirement for Type C reorganizations discussed below. Treas. Reg. § 1.368-2(b)(2); *see infra* note 37.

32. Note that triangular mergers may be structured in varying forms and under other reorganization types, such as Type B or C reorganizations. *See* 26 U.S.C. § 368(a)(2)(C)–(D) (2012). For an in-depth discussion of triangular tax-free reorganizations, see Stephanie Hoffer & Dale A. Oesterle, *Tax-Free Reorganizations: The Evolution and Revolution of Triangular Mergers*, 108 NW. U. L. REV. 1083 (2014).

purchasing corporation.[33] Type B reorganizations are less flexible than Type A reorganizations, and no boot may be given in a Type B reorganization.[34] In other words, *there is no boot in a B*.[35] Type C reorganizations are asset acquisitions where the acquiring corporation purchases the assets of the target corporation.[36] The target corporation is then required to distribute the consideration to its shareholders unless the IRS gives special permission.[37]

Type D reorganizations can be structured as either acquisitive reorganizations or divisive reorganizations. In Type D acquisitive reorganizations, a corporation transfers its assets to another corporation, and either the transferring corporation or some of its shareholders must be in control of the acquiring corporation after the transfer.[38] Type D acquisitive reorganizations provide substantial

33. 26 U.S.C. § 368(a)(1)(B) (2012).

34. Additionally, the acquiring corporation must have control over the target corporation immediately after the exchange. 26 U.S.C. § 368(a)(1)(B) (2012). The acquiring corporation has control, for purposes of § 368, when it acquires at least 80% of the combined voting power of stock and 80% of all other classes of stock. *Id.* § 368(c).

35. *Id.* § 368(a)(1)(B). This requirement is subject to a minor exception allowing cash to be paid in lieu of a fractional share. Rev. Rul. 66-365, 1966-2 C.B. 116, 117. There is an additional exception to this rule (although the IRS considers it as a separate exchange rather than an exception) that allows a debt-for-debt exchange in connection with a Type B reorganization. Rev. Rul. 98-10, 1998-1 C.B. 643.

36. 26 U.S.C. § 368(a)(1)(C)(2012). The acquiring corporation must purchase "substantially all of the properties" of the selling corporation. *Id.* This involves a factual analysis of the quantity and quality of the property transferred. *See* Robert A. Rizzi, *Corporate Organizations and Reorganizations: Quantity and Quality in the Substantially All Requirement*, 20 J. CORP. TAX'N 171 (1993). As a safe harbor, this requirement is met if the acquiring corporation receives 90% of the target corporation's net assets and 70% of the target corporation's gross assets. Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568. Additionally, at least 80% of the consideration paid to the target corporation must be the acquiring corporation's voting stock. 26 U.S.C. § 368(a)(2)(B)(iii) (2012). This requirement is more complicated when the acquiring corporation purchases less than 100% of the target corporation's assets. The statute requires that at least 80% of the corporation's *total* assets be paid for in voting stock. Thus, if the target corporation only sells 90% of its assets, the acquiring corporation must still exchange voting stock equal to the value of at least 80% of the corporation's total assets, limiting the amount of remaining consideration that may be boot. There are also special rules when the acquiring corporation assumes the liabilities of the target corporation. If the acquiring corporation does *not* use boot, the assumption of liabilities is not treated as boot. *Id.* § 368(a)(1)(C). But if the acquiring corporation uses boot, the assumption of liabilities will be treated as boot and will count against the 20% boot allowance. *Id.* § 368(a)(2)(B)(iii).

37. 26 U.S.C. § 368(a)(2)(G) (2012).

38. *Id.* § 368(a)(1)(D). The "continuity of interest" requirement is specifically excused for Type D acquisitive reorganizations; however, the continuity of interest requirement is inherent in the requirement that the transferee corporation or shareholders control the acquiring corporation. Treas. Reg. § 1.368-1(b)(as amended in 2011).

flexibility in structuring the transaction.[39] A Type D "divisive" reorganization occurs when one corporation is divided into two or more corporations by transferring part of its assets to another corporation and distributing the shares of the other corporation to its shareholders.[40]

The remaining categories of reorganizations relate to internal corporate restructuring. Type E reorganizations are recapitalizations;[41] Type F reorganizations are changes in identity, form, or place of organization;[42] and Type G reorganizations involve transfers in connection with a bankruptcy plan.[43]

C. Tax Consequences

Under the tax code, a sale or exchange of property results in a "realization" event where either gain or loss is realized.[44] Unless there is a specific exception in the code, realized gains or losses from sales of property must be "recognized" and included in gross income.[45] Section 354(a)(1) provides such an exception for shareholders (whether corporate or human) who, pursuant to a plan of reorganization, exchange securities in a corporation that is a party to a reorganization for securities in another corporation that is a party to the reorganization.46The corporations that are themselves the subjects of the reorganization will not recognize any gain on the corporate level if the transaction is structured properly.[47]

39. *See* Jasper L. Cummings Jr., *The Stockless D Reorganization Regulations*, 112 J. TAX'N 96 (Feb. 2010); Thomas W. Avent Jr., *Transfers of Assets to Controlled Corporations: The All Cash D Reorganization*, 32 CORP. TAX'N 3 (May/June 2005). Recent regulations state that the consideration may be 100% cash if the same shareholders own all the shares of the transferring corporation and the acquiring corporation in identical proportions. Treas. Reg. § 1.368-2(*l*)(2) (if the same shareholders own all of the shares of the transferring corporation and the acquiring corporation in identical proportions, the consideration may be purely in the form of cash and still qualify as a tax-free reorganization).

40. 26 U.S.C. § 368(a)(1)(D) (2012). This type of reorganization must meet additional requirements found in section 355.

41. *Id.* § 368(a)(1)(E). A recapitalization may occur, for example, when a shareholder exchanges his interest for a different kind of equity interest. Treas. Reg. § 1.368-2(e)(as amended in 2010).

42. 26 U.S.C. § 368(a)(1)(F) (2012).

43. *Id.* § 368(a)(1)(G).

44. *Id.* § 1001 (2012).

45. *Id.* §§ 1001(c); 61(a)(3), 1(a), 11(a).

46. *Id.* § 354(a)(1) (2012).

47. *Id.* § 361(a) (2012).

The tax consequences to shareholders are the focus of the 2016 revenue proposals and this Comment. Limitations exist on the nonrecognition rule provided for shareholders under section 354 that are not important for purposes of this comment.[48] But one important limitation under section 354(a)(1) is that the only property that can be exchanged is "stock or securities."[49] This apparently strict limitation is loosened by section 356(a), which provides that if something other than stock or securities is exchanged in an exchange that would otherwise qualify under section 354, then the shareholder will be taxed on the additional property received and nonrecognition treatment will still be available for the stock or securities.[50] This "other property received" is referred to as "boot." Boot may consist of any type of property, including cash.

The tax that would have been recognized by the shareholder, if not for the reorganization provisions, does not disappear, it is merely deferred. The shareholders take a basis in the property received tax-free (i.e., the stock or securities) equal to the basis the shareholders had in the property they surrendered.[51] The basis of the securities surrendered will typically be the original amount the shareholder paid for them.[52] If the shareholder later sells the securities received in the reorganization, the shareholder will be taxed on the amount for which the shareholder sold the securities less the shareholder's basis in the securities[53]—this is called "gain." Thus, shareholders will eventually be taxed on the securities received in a reorganization when the shareholders ultimately dispose of the securities.[54]

II. BOOT THAT HAS THE EFFECT OF A DIVIDEND

Section 356(a) provides relief to the strict requirement of section 354 that consideration be in the form of stock or securities:

48. For example, under § 354(a)(2), nonrecognition is only allowed to the point that the securities exchanged are equal in value and any excess will be taxable. Other limitations are found in § 354 but are not important for purposes of this Comment.

49. 26 U.S.C. § 354(a)(1) (2012).

50. *Id.* § 356(a).

51. *Id.* § 358(a). Special tracing provisions apply when a reorganization involves boot. Treas. Reg. § 1.356-1(b) (as amended in 2011). Typically the reorganization agreement should identify which shares are received in exchange for boot. *Id.* If the agreement fails to specify, then the boot will be applied against each security pro rata. *Id.*

52. 26 U.S.C. § 1012(a) (2012).

53. *Id.* § 1001(a) (emphasis added).

54. Assuming the securities are not held until death so that 26 U.S.C. § 1014 applies.

> (1) Recognition of gain
>
> If—(A) section 354 or 355 would apply to an exchange *but for the fact* that (B) the property received in the exchange consists *not only of property permitted by section 354* . . . but also of other property or money, *then the gain*, if any, to the recipient *shall be recognized*, but in an amount not in excess of the sum of such money and the fair market value of such other property.[55]

In other words, the shareholder will recognize any boot received in the transaction; however, the amount recognized is limited by the gain on the overall transaction. For example, if a shareholder exchanges stock with a basis of $100 for stock with a fair market value of $80 and $40 in cash in a qualifying reorganization, then the shareholder will only recognize $20 of the cash received because the total gain on the transaction was $20. This is known as the boot-within-gain limitation.

Historically, boot received in reorganizations was taxed at capital gains rates.[56] Congress became concerned that taxpayers were using boot payments in reorganizations to bailout corporate earnings and profits at capital gains rates.[57] In response to this concern, Congress added what is now section 356(a)(2) to the Internal Revenue Code in 1924:

> Treatment as dividend
>
> If an exchange is described in paragraph (1) *but has the effect of the distribution of a dividend* . . . , then there shall be *treated as a dividend* to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.[58]

This provision has remained largely unchanged since 1924[59] and has been subject to extensive criticism.[60]

55. 26 U.S.C. § 356(a)(1) (2012) (emphasis added).

56. *See* King, *supra* note 6, at 725–26; *cf.* 26 U.S.C. § 356(a)(2) (2012).

57. H.R. REP. NO. 68-179, at 14–15, (1924); S. REP. NO. 68-398, at 15–16 (1924).

58. 26 U.S.C. § 356(a)(2) (2012) (emphasis added).

59. *Id.*; *cf.* Internal Revenue Act of 1924, ch. 234, § 203(d)(2), 43 Stat. 253, 257.

60. *See infra* Part III.

The treatment of a "dividend" under section 356(a)(2) substantially differs from section 301's treatment of a dividend. First, it is limited by the "boot-within-gain limitation" described above.[61] Second, the dividend is limited to the shareholder's "ratable share" of earnings and profits.[62] Third, the dividend is only subject to the accumulated earnings and profits, as opposed to the current earnings *first* and *then* the accumulated earnings.[63]

Section 356(a)(2) also leaves several things uncertain. The statute does not say whether to look to the target corporation's or the acquiring corporation's earnings and profits. And, importantly, the statute, as well as the legislative history, is silent on the issue of *when* boot has the effect of a dividend.[64] Each of these issues is discussed in turn below after a general explanation of the taxation of dividends and purpose of section 356(a)(2).

A. Dividend Taxation and the Purpose of Section 356(a)(2)

Shareholders may receive money for their ownership interest in a corporation in various ways. First, a shareholder may simply sell his shares in the corporation to another party in an arms-length transaction. The shareholder will be able to offset the amount received against his basis and the gain on the sale will be taxed as capital gain.[65] Characterization of gain as capital gain is advantageous because capital gains are taxed at a lower rate than ordinary income.[66]

Alternatively, shareholders may receive money for their interest in a corporation through a redemption, where a corporation buys back its own stock from a shareholder.[67] The money the shareholder receives from the corporation may be characterized as either a sale

61. 26 U.S.C. § 356(a)(2) (2012). In contrast, dividends under section 301 are taxed on their entire amount. *Id.* §§ 301(a), (c), 316(a).

62. *Id.* § 356(a)(2). Earnings and profits are discussed in Section II.A. Contrast this provision with section 316(a), which subjects shareholders to the corporation's entire earnings and profits. *Id.*§ 316(a).

63. *Id.* § 356(a)(2). Compare with § 316(a), which states that a dividend is any distribution made from current earnings and profits first and then accumulated earnings and profits.*Id.*§ 316(a).

64. *See* King, *supra* note 6, at 727.

65. *See* 26 U.S.C. §§ 1221, 1222 (2012).

66. For example, in 2014, taxpayers whose taxable income falls in the 39.6% tax bracket are only taxed at 20% on their capital gains. *Id.* 1(h)(1)(D).

67. *Id.* § 317(b).

(subject to a basis offset and capital gains treatment), or as a dividend.[68] Section 302(b) gives several tests to determine if the money received should be treated as a sale. The overarching purpose of the tests is to give sale treatment to redemptions that "result in a *meaningful reduction* of the shareholder's proportionate interest in the corporation."[69] Section 302(b)(2) is a safe harbor for the meaningful reduction test. Section 302(b)(2) states that a meaningful reduction occurs when (1) "after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of [voting] stock," and (2) the percentage of voting and common stock "owned by the shareholder immediately after the redemption . . . is less than 80% of [the interest the shareholder had before the redemption]"—in other words, the shareholder's interest must decrease by more than 20%.[70] Section 302(b)'s meaningful reduction test is used in section 356(a)(2) to determine whether boot is taxed as a capital gain or if boot has the effect of a dividend.

Shareholders may also receive money for their ownership interest through dividends from the corporation. A dividend is defined in section 316(a) as a distribution from a corporation out of its current and accumulated earnings and profits ("earnings").[71] Therefore, money paid from a corporation to its shareholders is only a dividend to the extent of the corporation's earnings. For the sake of simplicity, earnings and profits can loosely be defined as profits (after expenses) that the corporation does not pay out to its shareholders.[72]First, the earnings of the current tax year are examined to determine if the amount is a dividend, and then the accumulated earnings of prior years are examined.[73] Thus, if a corporation made a profit in the year it paid money to its shareholders, but operated at a loss every prior year, the prior year losses would not offset the current year earnings

68. *Id.* § 302(a), (d).

69. United States v. Davis, 397 U.S. 301, 313 (1970).

70. 26 U.S.C. § 302(b)(2)(B), (C). Under section (C), shares of family members and related parties may be attributed to the shareholder. *Id.* § 302(b)(2)(C).

71. *Id.* § 316(a)(2012).

72. A more circumscribed, but still rough, definition of earnings and profits is taxable income plus excluded receipts (such as tax exempt income, e.g., interest from municipal bonds) minus nondeductible disbursements (e.g. federal tax payments). *See* 26 U.S.C. § 312(a) (2012); JEFFREY L. KWALL, THE FEDERAL INCOME TAXATION OF CORPORATIONS, PARTNERSHIPS, LIMITED LIABILITY COMPANIES, AND THEIR OWNERS 202 (4th ed. 2012).

73. Treas. Reg. § 1.316-2(a).

for purposes of determining whether the distribution was a dividend. If the corporation pays out any money in excess of its current year and accumulated earnings, that excess will first be offset by the shareholder's basis (and thus not be taxed).[74] If there is cash left over after being offset by the shareholder's basis, the excess is taxed as capital gain.[75]

If the corporation has sufficient earnings, then the entire amount of the distribution is included in the shareholder's gross income, and the shareholder's basis in stock of the corporation will not offset any of the amount taxed. Historically, dividends were taxed at higher rates than ordinary income.[76] Due to these tax consequences, shareholders may have a preference for receiving funds from the corporation that are characterized as capital gains.[77] This may drive a transaction to be structured so that taxpayers can bailout corporate earnings at capital-gains rates.[78] It was precisely this reason that prompted the creation of section 356(a)(2).

Section 356(a)(2) was promulgated to prevent abuse where boot paid in a reorganization is, in reality, a disguised dividend. The legislative history of section 356(a)(2) provides an illustration of the potential for abuse:

> Corporation A has capital stock of $100,000, and earnings and profits . . . of $50,000. If it distributes the $50,000 as dividend to its stockholders, the amount distributed will be taxed at the full surtax rates.
>
> On the other hand, Corporation A may organize Corporation B, to which it transfers all its assets, the consideration for the transfer being the issuance by B of all its stock and $50,000 in cash to the

74. 26 U.S.C. § 301(c)(2) (2012).

75. *Id.* § 301(c)(3).

76. Currently, the stakes aren't quite as high because dividends are taxed at the same rates as capital gains. *Id.* § 1(h)(11).. But this has only been the case since 2003. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27, 117 Stat. 752, 760–64 (codified as amended in scattered sections of 26 U.S.C. 752). Moreover, even though the tax rates are the same, dividends are *not* capital gains—thus, shareholders cannot offset dividends with basis.

77. 26 U.S.C. §§ 301(c)(1), 61(a)(7) (2012). A shareholder that is a corporation might prefer dividends to take advantage of the dividends-received deduction of section 243. *See* Rev. Rul. 72-327, 1972-2 C.B. 197 (dividend-boot from section 356(a)(2) qualifies for section 243 deduction).

78. *See, e.g.*, Daniel M. Schneider, *Internal Revenue Code § 355 Before and After the Tax Reform Act of 1986: A Study in the Regulation of Corporate Tax Bailouts*, 39 OKLA. L. REV. 567, 567–77 (1986).

> stockholders of Corporation A in exchange for their stock in Corporation A. Under the existing law, the $50,000 distributed with the stock of Corporation B would be taxed, not as a dividend, but as a capital gain, subject [to more favorable rates]. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the [favorable] rate on capital gain.[79]

To prevent "bailouts" of earnings at capital gains rates, section 356(a)(2) states that if boot has the effect of a dividend, it shall be treated as a dividend.[80] But section 356(a)(2) contains several provisions that have resulted in uncertainty, inconsistency in the code, and increased complexity.

B. The Boot-Within-Gain Limitation

Section 356(a)(2) incorporates section 356(a)(1)'s boot-within-gain limitation. Therefore, the boot treated as a dividend will only be recognized to the extent of gain on the overall transaction.[81] The boot-within-gain limitation is the most criticized way that section 356(a)(2)'s treatment of dividends is inconsistent with the rest of the Internal Revenue Code.[82]

The boot-within-gain limitation has recently received attention in the context of cross-border reorganizations. Consider the following example:

a) Parent, a United States corporation, owns FS1 and FS2, foreign subsidiary corporations;
b) Both FS1 and FS2 have substantial earnings that have not been taxed by the United States government;
c) FS2's stock is worth $100; Parent's basis in FS2 stock is $100;

79. H.R. REP. NO. 68-179, at 15 (1923).
80. 26 U.S.C. § 356(a)(2)(2012).
81. *See supra* note 58 and the accompanying text.
82. *See infra* Part III.

d) FS1 purchases FS2's stock from Parent for $90 cash and $10 worth of FS1 stock in a qualifying Type-D reorganization.[83]

In this transaction, Parent did not realize any gain.[84] Thus, under section 356(a)(2), Parent would not be taxed on the $90 of cash received. Since FS1 had earnings that were never taxed by the United States at the corporate level, Parent received $90 cash without paying any domestic taxes on it.[85]

The problem with the boot-within-gain limitation in section 356(a)(2) is not limited to repatriation of earnings. Domestic corporations can use a reorganization to bailout earnings without paying the second-level shareholder tax.[86] As a general policy matter, section 356(a)(1)'s boot-within-gain limitation rule makes sense because, if the boot is characterized as a sale, a sale would not be taxed if there was no gain on the sale. But when the boot is characterized as a dividend, the justification for this limitation falls apart because dividends are typically included in ordinary income and taxed in their entirety.

The boot-within-gain limitation is internally inconsistent with the Internal Revenue Code. Compare the limitation to section 301 where dividends are taxed in their entirety.[87] In section 302, if a redemption does not meet one of the 302(b) tests for sale treatment, it is treated as a distribution under section 301 and taxed in its entirety. In section 304, if a shareholder has a controlling interest in

83. This example is based on an example in Joseph M. Calianno & Brad Rode, *Navigating the IRS's Attack on Perceived Repatriation Transactions*, 39 TAX MGMT. INT'L J. 197, 205 (2010).

84. Additionally, the acquiring subsidiary could make a check-the-box election to change the target subsidiary's classification from a corporation to a disregarded entity. *See* Treas. Reg. § 301.7701-3(c) (1996). The target subsidiary would be deemed as distributing all of its assets to the acquiring subsidiary in liquidation, and the parent corporation would remove one layer of control between itself and the target corporation.

85. For further discussion on the use of section 356 to repatriate earnings from foreign subsidiaries, see Calianno & Rode, *supra* note 83, at 204.

86. Some commentators have even suggested that boot limited by section 356(a)(2)'s boot-within-gain limitation might cause the earnings of the target corporation to be reduced under section 312, even though the boot was not taxed. *Id.* at n.46 ("Since § 312 contains no specific rules about the effect of a boot-distribution on E&P, the general rules of § 312 seem to require a reduction in E&P by the amount of distribution without regard to the amount actually taxable to the recipient shareholders.") (quoting George C. Koutouras et al., "Boot Distributions and Assumption of Liabilities," 782-3d Tax Mgmt. (BNA) U.S. Income, at IV-C-8).

87. This assumes that there are sufficient earnings in the corporation so that section 301(c)(1) applies.

two corporations and corporation one buys the shareholder's stock in corporation two, the shareholder's interest in corporation two is subject to the section 302(b) test. If the shareholder fails, the entire amount received is taxed as a distribution under section 301. There is no clear policy reason for treating section 356(a)(2) dividends differently than these other sections.[88] As a matter of internal consistency, the boot-within-gain limitation of section 356(a)(2) needlessly complicates the tax code.

In a practical sense, the boot-within-gain limitation of section 356(a)(2) may only benefit shareholders seeking to avoid tax by bailing out corporate earnings. Some commentators suggest that section 356(a)(2)'s boot-within-gain limitation can only be explained as a drafting error.[89] Because of the "incoherent" nature of this rule,[90] Congress has been calling for its repeal off and on since 1954.[91] All attempts, both historical and recent, to eliminate the boot-within-gain limitation have failed.[92]

C. Ratable Share of Earnings

If boot has the effect of a dividend, section 356(a)(2) limits the boot that is treated as a dividend to the shareholder's ratable share of the earnings of the corporation. To illustrate, suppose that target corporation has $100 of earnings, shareholder owns 25% of target corporation, shareholder has zero basis in his stock, and shareholder receives $50 cash that has the effect of a dividend and $50 of stock in a reorganization. The shareholder will have $100 of gain and the $50 of cash will not be limited by the boot-within-gain limitation. But the shareholder's ratable share of the corporation's earnings is

88. Even past defenders of this rule were unable to answer why dividends should receive different treatment if received pursuant to a reorganization than if received from a traditional corporate distribution. *See, e.g.*, *Advisory Group Recommendations of Subchapters C, J, and K of the Internal Revenue Code: Hearing on H.R. 4459 Before the H. Comm. on Ways and Means*, 86th Cong. Congress, 745–800 (1959) (showing that at a Congressional hearing supporters of the boot-within-gain limitation testified that it was unfair to tax a shareholder on boot if the exchange resulted in loss to the shareholder, but were unable to explain why boot treated as a dividend in a reorganization should be treated differently than an ordinary dividend).

89. *See* Bruce D. Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX. L. REV. 573, 578–79 (1965).

90. S. REP. NO. 98-95, at 94 (1983) (Conf. Rep.).

91. King, *supra* note 6, at 728–31.

92. *See infra* text accompanying notes 8–1549.

only $25; therefore, only $25 of the boot received will be taxed as a dividend while the rest will be taxed as capital gain.

The ratable share rule is another way shareholders can bailout corporate earnings. There are many opportunities for shareholders in closely held corporations to structure a transaction to bailout earnings, especially since the attribution rules do not apply.[93] For example, Husband owns 75% of Mom & Pop Corporation and Wife owns 25%. Mom & Pop has $100 of earnings, and Husband and Wife both have zero basis in their shares. Mom & Pop is acquired in a qualifying reorganization for $200 of Acquiring Corporation stock and $100 cash, and Husband and Wife receive a proportionate share of stock and boot. Assume the exchange has the effect of a dividend. Husband would receive $75 cash and $150 of Acquiring stock and Wife would receive $25 cash and $50 of Acquiring stock. All $100 of boot received would be taxed as a dividend.

But Husband and Wife can structure the transaction above so that Wife receives all of the boot and $50 of Acquiring stock and Husband receives the rest of the stock. Only $25 of the boot will be taxed as a dividend because Wife's ratable share of the corporation's earnings is only $25. If section 356(a)(2) treated dividends consistently with the rest of the tax code, all $75 that Wife received would be taxed because all of the corporation's earnings would apply. This example demonstrates how the ratable share rule can lead to abuse in closely held corporations.

The ratable share rule also creates internal inconsistencies in the code. In sections 301(c) and 316, distributions to a shareholder are determined with reference to *all* of the corporation's earnings.[94] When applicable, the corporation's entire earnings are also used in redemptions under section 302 and sales to a related corporation under section 304. There is no convincing policy reason to give

93. 318(a) provides that an individual or entity may be deemed as owning the stock owned by other family members and entities. 26 U.S.C. § 318(a) (2012). Section 318(a) only applies when "the rules contained in this section are expressly made applicable." *Id*. In section 356(a)(2), attribution is only applied when determining whether boot has the effect of a dividend, not in determining the shareholder's ratable share of earnings. *Id*. § 356(a).

94. 26 U.S.C. § 316(a) (2012) ("Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits.").

different treatment to shareholders receiving boot deemed as a dividend under section 356.[95]

D. Accumulated Earnings

Section 356(a)(2) states that boot that has the effect of a dividend will be taxed to the extent of the shareholder's ratable share of the corporation's earnings "accumulated."[96] This provision could mean one of two things. At worst, it could mean that only the accumulated earnings, and not the current year earnings, are considered. At best, this provision means that the accumulated earnings may offset the corporation's current earnings. Both interpretations are unsatisfactory.

For sections 301, 302, and 304, the regulations in section 316 provide that, in determining whether a distribution is made out of the corporation's earnings, the earnings of the current tax year should be examined first.[97] Then, if the distribution exceeds the current year earnings, the accumulated earnings should be used to determine whether the excess is a dividend.[98] So, when a corporation makes a profit in the year it distributes money to its shareholders, but operates at a loss every prior year, the prior year losses will not offset the current year earnings for purposes of determining whether the distribution is a dividend.

Because section 316 distinguishes between accumulated earnings and current year earnings, section 356(a)(2) may be interpreted to mean that boot is only a dividend to the extent of accumulated earnings without counting current year earnings.[99] This interpretation is likely wrong.

95. In 1959, in a hearing before the Ways and Means committee, the stated purpose of the ratable share rule was to provide "for the treatment of boot received by holders of preferred stock." *Advisory Group Recommendations of Subchapters C, J, and K of the Internal Revenue Code: Hearing on H.R. 4459Before the H. Comm. on Ways and Means*, 86th Cong., 473, 546 (1959). Whatever merits this policy reason may have, it does not explain why the ratable share rule is also applied to holders of common stock.

96. 26 U.S.C. § 356(a)(2)(2012).

97. *Id.* § 316(a)

98. Treas. Reg. § 1.316-2(a).

99. *See* STAFF OF THE JOINT COMM. ON TAXATION, *Technical Explanation of the Revenue Provisions Contained in the "American Jobs and Closing Tax Loopholes Act of 2010," for Consideration on the Floor of the House of Representatives*, JCX-29-10, at 303 (2010) (hereinafter "JCT Explanation") (proposing to eliminate section 356(a)(2)'s reference to "accumulated" earnings, so "that earnings and profits references in section 356(a)(2) not be interpreted to exclude current year earnings and profits").

Prior to 1936, the predecessor to section 316 simply referred to distributions out of "accrued" earnings.[100] During this time, distributions were determined by current year earnings as well as accumulated earnings.[101] In 1936 Congress amended the predecessor to section 316 to state a separate category of distributions out of the *current year's* earnings so that taxpayers could receive credits against an undistributed profits surtax, now defunct, when the corporation had operated at a loss in prior years and would otherwise be unable to pay a dividend.[102]

Present-day section 356(a)(2) was drafted prior to the 1936 amendment to present-day section 316.[103] Because both current year and accumulated earnings were used before the amendment to section 316, the better interpretation of section 356(a)(2) is that the current year earnings and the prior year losses will be used to determine the amount of the distribution taxed as a dividend.[104] Either way, there is no logical reason why distributions under section 356(a)(2) should be limited in this way when they are not limited in the rest of the code.

E. Earnings of Which Corporation?

Section 356(a)(2) directs that, in determining how much of the deemed dividend is taxed as a dividend, the ratable share of the accumulated earnings of "the corporation" must be taken into account. The statute leaves open the question of *which* corporation's earnings must be taken into account—target or acquiring.

For corporations whose ownership is not identical, the IRS and courts have stated that only the earnings of the target corporation are

100. *See* Harry J. Rudick, *"Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions*, 89 U. PA. L. REV. 865, 867 (1941).

101. *See id.* at 867–69; *see also* Lynch v. Hornby, 247 U.S. 339, 344 (1918) ("Dividends are . . . expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based on the increased value of the property of the corporation.").

102. *See* Rudick, *supra* note 100 at 868–69. Rudick argues that the distinction in section 316 should be done away with and that shareholders should be able to offset current year earnings against prior deficits. *Id.* at 904–05. Perhaps Rudick would support the current language of section 356(a)(2).

103. *See* Internal Revenue Act of 1924 § 203(d)(2), 43 Stat. 253 (1924).

104. *Cf.* Vesper Co. v. Comm'r of Internal Revenue, 131 F.2d 200, 205 (8th Cir. 1942) (holding that both current and accumulated earnings are taken into account in interpreting a statutory provision regarding redemptions with language similar to section 356(a)(2)).

taken into account.[105] Although the language in the statute is ambiguous, this conclusion makes sense because section 356(a)(2) was drafted to address the bailout of the target corporation's earnings.[106]

The harder question is which corporation's earnings should be considered when the corporations' ownership is identical. Courts are split on this question. The IRS and the Fifth Circuit believe that the earnings of both corporations should be taken into account because when "there is complete identity . . . the stockholders control both corporations and it is virtually impossible to tell which corporation is in reality 'the corporation' distributing the cash." [107] But the Third Circuit and the Tax Court take the view that only the target corporation's earnings should be taken into account.[108] Although the Tax Court and Third Circuit's position may seem counterintuitive, the plain language of the statute seems to support this result.[109] This provision creates uncertainty for taxpayers and "it is up to Congress to correct this defect."[110]

F. When Does Boot Have the Effect of a Dividend?

Section 356(a)(2) only applies when boot has the effect of a dividend. But Congress failed to mention when boot has the effect of a dividend. Instead, Congress left this messy question for the courts to deal with.

The first judicial decisions to decide the matter held that all boot received pursuant to a reorganization had the effect of a dividend.[111]

105. Rev. Rul. 75-83, 1975 C.B. 112 ("[R]egardless of which corporation makes a distribution, the amount of the dividend is measured by reference to the earnings and profits of the transferor."); *see, e.g.*, Ross v. United States, 173 F. Supp. 793 (Ct. Cl. 1959); Hawkinson v. Comm'r, 235 F.2d 747 (2d Cir. 1956); Comm'r v. Owens, 69 F.2d 597 (5th Cir. 1934).

106. *See supra* Part II.A.

107. Davant v. Comm'r, 366 F.2d 874, 889 (5th Cir. 1966); Rev. Rul. 70-240, 1970-1 C.B. 81.

108. Atlas Tool Co. v. Comm'r, 614 F.2d 860, 867–68 (3d Cir. 1980); Am. Mfg. Co. v. Comm'r, 55 T.C. 204, 224–31 (1970).

109. *See Am. Mfg. Co.*, 55 T.C. at 231.

110. *Id.*

111. *See e.g.*, *Owens*, 69 F.2d at 598; Knapp Monarch Co. v. Comm'r, 1 T.C. 59 (1942); J. Weingarten Inc. v. Comm'r, 44 B.T.A. 798, 805–10 (1941); McCord v. Comm'r,, 31 B.T.A. 342 (1934); Woodard v. Comm'r,, 30 B.T.A. 1216, 1227–28 (1934). The Supreme Court even seemed to adopt this automatic dividend rule in *Comm'r v. Bedford's Estate*, where it held that cash received in a recapitalization reorganization, where the corporation has sufficient earnings,

This so-called "automatic dividend rule" makes sense from a strict policy perspective. If reorganizations are simply a "mere change in form" of the corporation,[112] then any cash received must necessarily be a dividend because the shareholder's interest in the corporation does not change, it just continues on in another form. But this ignores the law that has developed around reorganizations which allows shareholders to sell a limited amount of their interest and still qualify for tax-free treatment.[113]

The automatic dividend rule was widely criticized and did not last very long.[114] The IRS abandoned the automatic dividend rule and took the position that the test to determine section 356(a)(2) dividend equivalency should be similar to the tests in section 302(b).[115] Courts followed this approach, but differed on how they applied section 302(b) to reorganizations.

Two competing views emerged. The first, called the *Shimberg* test, treated the boot as a hypothetical redemption of the target corporation's stock *before* the reorganization.[116] The second approach, called the *Wright* test, treated the boot as a hypothetical redemption of the acquiring corporation's stock *after* the reorganization.[117] The Supreme Court resolved this split in *Commissioner v. Clark* and adopted the *Wright* test (now called the *Clark* test).[118]

In *Clark*, the taxpayer was the sole shareholder of a corporation.[119] The taxpayer's corporation merged with a much larger publicly traded corporation. Initially, the acquiring corporation offered the taxpayer 425,000 shares of the acquiring corporation for all of the target corporation's shares.[120] The taxpayer turned down

is a dividend. 325 U.S. 283, 290–91 (1945). The Court even went a step further in dicta suggesting that the same result may be reached in acquisitive reorganizations. *Id.*

112. *See supra* Part II.A.

113. *See supra* notes 16–20 and accompanying text.

114. *See* King, *supra* note 6 at 734; Stephen Massey, *Boot Distributions in Corporate Reorganizations: Dividend Equivalence and the Continuity of Interest Doctrine*, 32 U. FLA. L. REV. 119, 132 (1980).

115. Rev. Rul. 74-515, 1974-2 C.B. 118; Rev. Rul. 74-516, 1974-2 C.B. 121.

116. Shimberg v. United States, 577 F.2d 283, 288–89 (5th Cir. 1978).

117. Wright v. United States, 482 F.2d 600, 606–08 (8th Cir. 1973).

118. Comm'r v. Clark, 489 U.S. 726, 737–40 (1989).

119. *Id.* at 731.

120. *Id.*

that offer and accepted a counter-offer for 300,000 shares of the acquiring corporation and $3,250,000 cash.[121]

Under the *Shimberg* test the taxpayer had a 100% interest in the target corporation before the reorganization. The taxpayer would be deemed to have sold a certain amount of shares to the target corporation for the cash. The taxpayer's interest in the target corporation after this hypothetical redemption—deemed to occur before the reorganization—would still be 100%. Because this is not a meaningful reduction in interest, the boot would be deemed a dividend. The Court recognized that the *Shimberg* test will result in dividend treatment any time shareholders receive boot pro rata in a reorganization.[122] Because it is often the case that boot will be distributed pro rata, the Court adopted the *Wright* test instead.[123]

Following the *Wright* test, the taxpayer was treated as receiving the full 425,000 shares originally offered and then redeeming 125,000 of those shares—to reflect his actual interest in the acquiring corporation of 300,000—*after* the reorganization.[124] Viewed this way, the taxpayer's interest in the acquiring corporation was 1.30% before the redemption and 0.92% after the deemed redemption.[125] This reduction in interest qualified for sale treatment under the section 302(b) 50/80 test[126]discussed in section II.A. The Supreme Court concluded that the boot did not have the effect of a dividend and that the boot should be taxed as capital gain.[127]

An important policy driving this decision was that the Supreme Court did not want every pro rata distribution of cash to result in a dividend.[128] The Court also reasoned that dividend treatment is meant to be the exception to capital gains treatment in section 356.[129] The Court recognized, however, that both of the competing views were "somewhat artificial" and chose the test that was "less artificial."[130]

121. *Id*
122. *Id*. at 739.
123. *Id*.
124. *Id*. at 740.
125. *Id*.
126. *Id*.
127. *Id*.
128. *Id*. at 738–39.
129. *Id*. at 739.
130. *Id*. at 741.

The test for whether boot has the effect of a dividend has been resolved by *Clark*. But the *Clark* test is not a perfect test. *Clark* was simply a choice between the lesser of two evils. Congress should finish the job they started ninety years ago by clarifying when boot has the effect of a dividend and supplanting *Clark* with a test that is less artificial.

III. FIXING SECTION 356(A)(2)

Due to the shortcomings of section 356(a)(2) discussed above, section 356(a)(2) has been attacked by Congress on-and-off for the last sixty years.[131] Section 356(a)(2)'s boot-within-gain limitation, in particular, has been subject to widespread criticism.[132] The Obama administration began targeting section 356(a)(2)'s boot-within-gain limitation in 2009. In February 2015, the Obama administration proposed repealing the boot-within-gain limitation and aligning section 356(a)(2)'s treatment of earnings with section 316.[133] On May 28, 2010, the House approved a bill that would have substantially revised section 356(a)(2);[134]however, the revision did not make it into final law.[135]

Section 356(a)(2) can be improved by building on the Obama proposals and the 2010 House bill. In addition, Congress should amend section 356(a)(2) to explicitly direct when boot will have the effect of a dividend. This amendment should supplant the *Clark* rule with a test that compares the shareholder's economic interest in the target corporation before the reorganization with the shareholder's interest in the acquiring corporation after the reorganization.

131. For a comprehensive treatment of these attacks, see King, *supra* note 6, at 728–31.

132. *See, e.g.*, Jasper L. Cummings, Jr., *Form vs. Substance in the Treatment of Taxable Corporate Distributions*, 85 TAXES 119, 129 (2007) (stating that "there is no known reason" for the boot-within-gain limitation); Seth Green & Stafford Smiley, *The Curious Case of the Partial Loophole Closer*, CORP. TAX'N, Jan./Feb. 2010, at 38; Bruce D. Shoulson, *Boot Taxation: The Blunt Toe of the Automatic Rule*, 20 TAX L. REV. 573, 578–79 (1964) (stating that the boot-within-gain limitation was a drafting error).

133. 2016 Revenue Proposals, *supra* note 7, at 121.

134. American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. § 422 (2010) [hereinafter 2010 House Bill].

135. *See* Unemployment Compensation Extension Act of 2010, Pub. L. No. 111-205, 124 Stat. 2236 (2010).

A. Fixing Section 356(a)(2) with the House Bill and the Obama Proposal

The 2016 Revenue Proposals and the 2010 House bill would both amend section 356(a)(2) to be more consistent with the rest of the Internal Revenue Code. Section 356(a)(2) should be revised using the Obama proposal and the 2010 House bill as a template with further improvements discussed below.

The Obama proposal specifically proposes repealing the boot-within-gain limitation.[136] The 2010 House bill also would repeal the limitation by striking the following language: "then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1)."[137] Repealing the boot-within-gain limitation is an important way section 356(a)(2) can be amended to stop abusive bailouts—as discussed in Section II.B— and bring section 356(a)(2)'s treatment of dividends in conformity with the rest of the Internal Revenue Code.

Prior to the 2016 Revenue Proposals, the Obama administration only targeted the ratable share provision of section 356(a)(2).[138] In the 2016 Revenue Proposals, the Obama administration "proposes to align the available pool of earnings and profits to test for dividend treatment with the rules of section 316 governing ordinary distributions."[139] This would presumably eliminate both the ratable share provision and section 356(a)(2)'s reference to accumulated earnings. This would be a positive change that would eliminate the potential for abuse in closely held corporations and create consistency with the rest of the code.[140]

The 2010 House bill accomplished the task of eliminating both the ratable share provision and the accumulated earnings provision by striking them and stating "then the amount of other property or money shall be treated as a dividend to the extent of the earnings and profits of the corporation."[141] The Joint Committee on Taxation

136. *See* 2016 Revenue Proposals, *supra* note 7, at 121.

137. *See* 2010 House Bill, *supra* note 134, § 422.

138. *See* DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2015 REVENUE PROPOSALS 96 (2014), *available at* http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2015.pdf.

139. 2016 Revenue Proposals, *supra* note 7, at 121.

140. *See infra* Part III.C.

141. *See* 2010 House Bill, *supra* note134 § 422.

explained that the language in the 2010 House bill treats boot as a dividend to the extent of all earnings of the corporation and prevents any interpretation that excludes current year earnings.[142] This language should be adopted and then improved by clarifying that "dividend" in section 356(a)(2) should have the same meaning as section 316: "then the amount of other property or money shall be treated as a dividend *as defined in section 316*."[143]

The 2010 House bill went further than the Obama proposals by adding a new subsection to section 356(a)(2). This subsection directed that the earnings of both the acquiring and the target corporation should be taken into account in Type D acquisitive reorganizations and "any other reorganization specified by the Secretary."[144] This would effectively adopt and broaden the IRS and Fifth Circuit's view that earnings of both corporations should be taken into account when the ownership is identical. The House bill also directed that the amount which is a dividend will be determined under rules similar to section 304(b)(2) and (5),[145] meaning that in most situations the earnings of the acquiring corporation will be looked at first (and reduced) followed by the earnings of the target corporation. This provision would solve a question left unanswered by section 356(a)(2) and should be adopted.

The new subsection would apply to Type D acquisitive reorganizations as well as "other reorganization[s] specified by the Secretary."146 The Joint Committee on Taxation explained that these other reorganizations may be triangular reorganizations that involve common control, but that the Secretary is not limited to triangular reorganizations.[147] This broad grant of authority to the Treasury may create some uncertainty. The new subsection could be

142. *See* JCT Explanation, *supra* note 99, at 302–03.

143. It would be more consistent to borrow language from section 302(d) and state: "then the amount of other property or money shall be treated as a *distribution of property to which section 301 applies*." However, this language would change the practice in section 356(a)(2) of treating boot that has the effect of a dividend as a dividend to the extent of earnings and any excess as capital gain as opposed to a return of capital. *See* 26 U.S.C. § 301(c) (2012). In drafting the 2010 House bill, Congress intended that the practice of dividend treatment first then capital gain treatment remain intact. *See* JCT Explanation, *supra* note 99, at 302.

144. *See* 2010 House Bill, *supra* note 134, § 422.

145. *Id.*

146. *Id.*

147. *See* JCT Explanation, *supra* note 99, at 303.

improved by narrowing this grant of authority to reorganizations between parties under common control. Adding this provision would also validate the current practice of only looking to the target corporation's earnings when ownership is not identical; however, legislative acquiescence is not typically viewed as a strong indicator of legislative intent.[148] The provision could therefore be improved by stating that earnings of the target corporation will be the only earnings looked to except as otherwise specified.

If the boot-within-gain limitation were repealed and the other recommended changes to section 356(a)(2) were adopted, there would be greater consistency in the tax code and tax loopholes would be closed. But another consequence would be an increase on the amount of boot that would be taxed if the boot has the effect of a dividend. Because the boot-within-gain limitation will survive under section 356(a)(1) when boot does *not* have the effect of a dividend, taxpayers will prefer to fall under section 356(a)(1). Therefore, Congress should provide a clear statutory test for when boot has the effect of a dividend and replace the *Clark* test with something less "artificial."

B. Fixing the Test for When Boot has the Effect of a Dividend

The Obama proposals and the 2010 House bill do not change the test for dividend equivalency. Because changes to section 356(a)(2) would raise the stakes for taxpayers, the *Clark* test should be supplanted with a test that more accurately reflects the economic realities of a reorganization. This proposed test, hereafter referred to as "*Old Shimberg*" (which is the same test the district court used in *Shimberg*[149]—hence the name *Old Shimberg*), compares the shareholder's interest in the *target* corporation before the reorganization with the shareholder's interest in the *acquiring* corporation after the reorganization.

The Supreme Court rejected the *Shimberg* test because it would cause every pro rata distribution of boot to have the effect of a dividend.[150] This was the correct result,[151] but, as the Supreme Court

148. William N. Eskridge, Jr., *Interpreting Legislative Inaction*, 87 MICH. L. REV. 67 (1988).

149. Shimberg v. United States, 415 F. Supp. 832 (M.D. Fla. 1976), *rev'd*, 577 F.2d 283 (5th Cir. 1978).

150. *See supra* note 123 and accompanying text.

recognized,[152] *Clark* has its own shortcomings. First, *Clark* only looks at one side of the transaction and ignores the shareholder's interests in relation to *other* target shareholders' interests. Second, *Clark* does not account for preexisting interests a shareholder may have in the acquiring corporation. This can lead to abuse where a shareholder of the acquiring corporation is also a shareholder of the target corporation.

For example, assume that S owns 25 out of 100 shares in the target corporation and 50 out of 100 shares in the acquiring corporation. The acquiring corporation acquires the target corporation in a qualifying reorganization for 100 newly issued shares of the acquiring corporation. As controlling shareholder of the acquiring corporation, S modifies the deal so that he receives cash for his target stock instead of acquiring corporation stock. Under the *Clark* test, S is deemed to have received 25 shares of the acquiring corporation's stock to add to the 50 shares he already owns, 200 shares of the acquiring corporation stock are deemed outstanding, and S has a 38% interest in the acquiring corporation after the reorganization. Then, S's 25 shares are redeemed, the acquiring corporation only has 175 shares outstanding, and S has a 29% interest in the acquiring corporation.[153] Under section 302(b), S'spost-redemption ownership is less than 80% (76% in this case) of his pre-redemption ownership in the acquiring corporation.[154] Therefore, the boot does not have the effect of a dividend and the boot is taxed as capital gain. But this result should not be correct because S has effectively increased his ownership interest in the target corporation from 25% to 29%.

Comparing S's ownership in the target corporation *before* the reorganization to S's ownership interest in the acquiring corporation *after* the reorganization would solve this problem.[155] In the situation above, S would own 25% before the reorganization and 29% after the reorganization. This is a 116% increase in interest.[156] Therefore, the

151. *See* Michael L. Schler, *Rebooting Section 356: Part 1—The Statute*, TAX NOTES, July 19, 2010, at 299.

152. *See supra* note 131 and accompanying text.

153. 50 shares owned divided by 175 shares outstanding.

154. 29% actual interest divided by the 38% deemed interest.

155. *See* Schler, *supra* note 152, at 299–300 (arguing that the dividend equivalency test should be applied using the *Old Shimberg* methodology).

156. 29% post-acquisition interest divided by the 25% pre-acquisition interest.

boot would have the effect of a dividend. This reflects the economic reality of what happened: S used his position in the acquiring corporation to give himself cash in the transaction. Under *Clark*, S is able to bailout corporate earnings while avoiding dividend treatment. *Old Shimberg* closes this loophole.

Old Shimberg would provide the same result as *Clark* in other circumstances where *Clark* reaches the right result. In the case of *Clark* itself, *Old Shimberg* would compare the taxpayer's 100% interest in his corporation to his 0.92% interest in the acquiring corporation and the boot would be treated as capital gain.[157] But *Old Shimberg* fixes *Clark's* shortcomings by looking at both sides of the transaction and considering shareholders' preexisting interests in the acquiring corporation.

The Fifth Circuit overturned *Old Shimberg* because the boot distribution was pro rata.[158] Because the boot distribution was pro rata, the target corporation shareholders could not have had a meaningful reduction in their interests in the target corporation.[159] But as the Supreme Court in *Clark* pointed out, this effectively brought back the automatic dividend rule.[160] Unfortunately, the *Old Shimberg* test was not considered in *Clark*.

Arguably, *Old Shimberg* has one shortcoming. As the Fifth Circuit pointed out in rejecting *Old Shimberg*, any time the acquiring corporation is considerably larger than the target corporation the boot will be treated as capital gain.[161] However, this shortcoming is not a shortcoming of *Old Shimberg*; it is a shortcoming of the current state of the continuity of interest doctrine.[162] Any time a closely-held corporation is acquired by a large, publicly-held corporation the shareholders who controlled the closely-held

157. *Old Shimberg* will reach the same result as *Clark* when a shareholder receives a disproportionate amount of boot in a reorganization. For example, say S owns 20 out of 100 shares of the target corporation and no shares of the acquiring corporation. In a qualifying reorganization, all of the shareholders receive one share of the acquiring corporation for each of their shares in the target corporation. But S receives only 10 shares and some cash. Under *Clark*, S would go from 10% to 5% resulting in capital gains treatment. Under *Old Shimberg*, S would go from 20% to 5% resulting in capital gains treatment.

158. Shimberg v. United States, 577 F.2d 283, 289 (5th Cir. 1978).

159. *Id*.

160. Comm'r v. Clark, 489 U.S. 726, 739 (1989).

161. *Shimberg*, 577 F.2d at 288.

162. The current state of the continuity of interest doctrine and its effect on the overall reorganization regime is briefly discussed in Part IV.C.

corporation become mere profit shareholders—that is, shareholders without a controlling interest in the target corporation as an ongoing concern. The continuity of interest doctrine allows this result by only focusing on the nature of the consideration in a reorganization and not requiring shareholders to retain control.

Because the continuity of interest doctrine allows controlling shareholders to sell their corporation and become insignificant shareholders in the acquiring corporation, *Old Shimberg* accurately reflects economic realities by giving capital gains treatment to such reorganizations. The *Old Shimberg* court illustrated this reality:

> No longer was [the former majority stockholder of the target corporation] the major 'owner' of a successful local company . . . . He was then the holder of a miniscule percentage of the outstanding stock of a huge, publicly-held corporation. It is clear that the merger resulted in a radical change and meaningful reduction in the nature of the [taxpayer's] interest in the continuing business. The net effect of the transaction was a sale by the [taxpayer] . . . of [his] LSC stock to MGIC for cash and marketable securities in a publicly owned corporation.[163]

In sum, because the recommended revisions to section 356(a)(2) would increase the amount of boot subject to tax, Congress should specify when boot has the effect of a dividend. Congress should statutorily adopt *Old Shimberg* as the test for when boot has the effect of a dividend.[164] This test closes loopholes and more accurately reflects the economic realities of reorganizations by comparing ownership interests before and after the reorganization.

C. Afterword: Fixing the Continuity of Interest Doctrine

As an afterword, it is worth discussing the conflict the current approach to dividend equivalency has with the continuity of interest doctrine. The current approach uses principles from section 302 to determine if boot has the effect of a dividend.[165] The section 302 test determines whether a redemption of stock by a shareholder results in enough of a "meaningful reduction in interest" to tax the property received as capital gain. In other words, the redemption test seeks to determine *discontinuity* of interest. Tax-free reorganizations, on the

163. Shimberg v. United States, 415 F. Supp. 832, 836–37 (M.D. Fla. 1976).

164. *See* Schler, *supra* note 152, at 300 (arguing the same).

165. *See supra* Part II.F.

other hand, are premised on the idea that shareholders are continuing their interest in the corporation and, therefore, no taxable sale has taken place.[166] This practice of applying section 302 to section 356 may seem suspect. But as one commentator points out, the problems in the current regime do not stem from this inherent conflict, but instead stem from the current state of the continuity of interest doctrine.[167]

The general rule for continuity of interest is that at least 40% of the *consideration* received must be the acquiring corporation's stock.[168] But if continuity of interest required the shareholders to collectively obtain a substantial continuing *ownership interest* in the acquiring corporation, then the concern of shareholders selling their interest but receiving tax-free treatment disappears. And the uncomfortableness of applying section 302 to section 356 disappears. This is because, although the individual shareholder may have cashed-out some of his interest, the shareholders as a whole will have a substantial continuing interest in the acquiring corporation.[169] Compare this to the current regime where the shareholders of a corporation may reduce their collective ownership of 100% in the target corporation to 3% in the acquiring corporation. As long as 40%[170] of the consideration is paid in stock, the shareholders' interests are deemed to continue for purposes of the continuity of interest requirement.

This issue has been covered elsewhere[171] and is outside of the scope of this Comment, which focuses on section 356(a)(2) specifically. But this issue is mentioned because a total fix to section 356(a)(2) may require a fix to the principal rule underlying tax-free reorganizations.

IV. CONCLUSION

The Obama administration and the House of Representatives have recently made efforts to reform section 356(a)(2). Section

166. *See supra* Part I.A.

167. *See* Massey, *supra* note 114, at 139–40.

168. *See supra* Part II.B..

169. *See* Massey, *supra* note 114, at 140.

170. Note that 40% is a minimum threshold. Different types of reorganizations may set out stricter requirements.

171. *See, e.g.*, Massey, *supra* note 114; See also Skillman, *supra* note 12, for a more generalized discussion on the underlying policies and doctrines of tax-free reorganizations.

356(a)(2) treats dividends inconsistently with the rest of the code without justification. Section 356(a)(2) also leaves taxpayers with uncertainty as to how several of its provisions apply. It also provides opportunities for tax avoidance. The boot-within-gain limitation has received particular attention by the Obama administration, as well as commentators, because of the opportunity it creates for repatriation of offshore earnings and general tax avoidance.

Section 356(a)(2) should be amended to fix these problems by adopting the Obama proposals and the 2010 House bill amendments along with the recommendations discussed above. These revisions would eliminate the boot-within-gain limitation and the ratable share rule. The revisions would direct that earnings of the current year be counted first, followed by accumulated earnings. And the revisions would clarify whose earnings must be considered. These changes would make section 356(a)(2) consistent with the rest of the code and eliminate opportunities to bailout corporate earnings.

Congress should also amend section 356(a)(2) to state when boot has the effect of a dividend. The amendment should supplant the current *Clark* rule with the *Old Shimberg* rule. The *Old Shimberg* rule compares the shareholder's interest in the target corporation before the reorganization with the shareholder's interest in the acquiring corporation after the reorganization and determines whether there has been a meaningful reduction in interest under section 302(b). This test more accurately reflects the economic realities of a reorganization. Specifically, it improves on the *Clark* test by taking into account the shareholder's interest on both sides of the transaction and by accounting for preexisting interests in the acquiring corporation.

*Trevor Crowley**

*JD, April 2014, J. Reuben Clark Law School, Brigham Young University.