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BOOTSTRAPS AND CAPITAL GAIN—A PARTICIPANT'S VIEW OF *COMMISSIONER v. CLAY BROWN*

*William H. Kinsey**

I. Background of *Commissioner v. Clay Brown*[1]

A closely held corporation may be sold in a variety of ways. At one end of the spectrum is an all-cash sale. In such a transaction, the seller receives the purchase price and has no further concern with the economic well-being of the business. The difficulty with this method, of course, is finding a purchaser with sufficient cash who is willing to pay a fair price.

At the other end of the spectrum is a full-fledged bootstrap sale, where there is no down payment other than from the underlying assets of the sold corporation, and the purchaser's obligation to pay the purchase price over a period of years is dependent upon income generated by the underlying corporate assets and upon the assets themselves. Because of this dependency, a bootstrap seller remains vitally interested in the economic well-being of the corporation until the purchase price is fully paid.

Between these two extremes are sales where some down payment is made from independent sources, and the purchaser assumes personal liability for all or a portion of the purchase price. The significance of the purchaser's assumption of personal liability naturally depends upon his financial affluence.

A. *Impact of Capital Gain Treatment*

A motivating factor in any sale of a closely held corporation is the ability of the seller to report his profit as long-term capital gain. Few closely held corporations would be sold for an all-cash purchase price if the gains from such sales were taxable as ordinary income. Similarly, few bootstrap transactions would be undertaken if the resulting gains were taxable as ordinary income. Denying capital-gain treatment to either type of sale may have the practical effect of banning such sales.

The purchase price in a bootstrap sale may be greater than the purchase price in an all-cash sale. However, it is no more accurate

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1. 380 U.S. 563 (1965).

to assume that the purchase price in a bootstrap sale is unreasonably high than it is to assume that the purchase price in an all-cash sale is unreasonably low. Neither the possibility of an excessive purchase price nor the possibility of other abuse is sufficient reason to ban bootstrap sales through judicial determination that they fail to comply with the "sale" prerequisite for capital-gain treatment. This was the broad holding of the Supreme Court in *Commissioner v. Clay Brown*. An understanding of the case may be facilitated by a review of the nature and mechanics of bootstrap sales along the lines presented to the Supreme Court in the taxpayers' brief.

B. *Typical Bootstrap Situation*

In a typical bootstrap situation, *S* owns all the stock of corporation *X*, which *S* believes to be worth a specified sum. *P*, perhaps a key employee, desires to purchase corporation *X*, but he may not have sufficient cash to pay the price demanded by *S*. Nevertheless, *S* may be willing to entertain a purchase offer from *P* under an arrangement whereby *P* will pay the agreed price over a reasonable period of time with funds generated by the *X* assets.

If *P* purchases the *X* stock and pays the purchase price from after-tax income of *X* distributed to *P* as dividends, each dollar of income generated by the *X* assets will be subject to the corporate tax and also to the tax on *P*'s personal income. Assuming a 52 per cent corporate tax rate,[2] 48 cents would remain out of each generated dollar after payment of the corporate tax. If the dividends subject *P* to a 70 per cent individual tax rate, the 48 cents less the 70 per cent individual tax would leave a net 14.4 cents out of each dollar generated by the *X* assets for payment by *P* upon the purchase price. Obviously, *P* must devise a better proposition if he is to interest *S* in selling corporation *X* under an arrangement where the purchase price will be paid out of income generated by the *X* assets.

1. *Standard Plan for Bootstrap Sales*

Elimination of the necessity for dividend extraction in the foregoing purchase plan would subject each generated dollar to only the corporate tax, thus leaving 48 cents for payment upon the purchase price. A more or less standard plan accomplishes this objective. *P* forms new corporation *Y* with nominal capital, and *Y* (not *P*) pur-

2. Although the present corporate tax rate on net income in excess of $25,000 is 48%, a 52% rate is assumed in this article because that rate was in effect during the years involved in the *Clay Brown* case.

chases the *X* corporation stock from *S* for a price payable over a period of years.[3] Forthwith, corporation *X* is liquidated into *Y*, with corporation *Y* taking over all of the assets and liabilities of *X*.[4] Upon receipt of the *X* assets, corporation *Y* grants a mortgage thereon to *S*, securing *Y*'s obligation to pay the purchase price. The stock of corporation *Y* may be deposited in escrow as additional collateral security. Corporation *Y* pays the purchase price out of income generated from its ownership and operation of the former *X* assets. The income generated by corporation *Y*'s operation of the former *X* assets is not taxed as a dividend to *P* (or anyone else) when paid upon the purchase price. No dividend distributions are required, since the purchase-price obligor and the owner and operator of the assets are the same entity.

While the standard plan assures a minimum of 48 cents out of each dollar generated by the underlying corporate assets for payment upon the purchase price, it is not easy to pay for a business with 48-cent dollars. The objective is to obtain something in excess of the 48-cent minimum, and this may be possible as a result of the additional cash flow available to purchasing corporation *Y*, which was not available to acquired corporation *X*. Cash flow is net taxable income plus depreciation and other deductions not requiring a cash outlay. For example, if a corporation has $100,000 of income and $50,000 of depreciation, the corporation has $50,000 of net taxable income ($100,000 less $50,000 depreciation) subject to a tax of $26,000 (52 per cent of $50,000), leaving $74,000 available for payment upon the purchase price. Assuming that the foregoing reflects the amount of depreciation available to *Y* corporation after the con-

3. Since the purchase price is payable over a period of years, *S* desires to report the purchase price on the installment basis. This accounts for *S*'s selling the stock rather than having *X* corporation sell assets to new corporation *Y*. If *X* corporation sold assets, it would be necessary to comply with § 337 of the Internal Revenue Code to preclude recognition of gain upon the sale. Qualification under § 337 requires complete liquidation of corporation *X* within twelve months, and distribution of corporation *P*'s obligation to pay the balance of the purchase price would result in immediate capital gain tax to *X* based on the present value of the deferred payments. All of this is avoided, and *S* is entitled to elect the installment method under § 453(b)(1)(B), when he sells stock and does not receive more than 30% of the purchase price during the year of sale.

4. No gain is recognized to *X* corporation on the distribution of its assets to *Y* corporation as liquidating distributions. See INT. REV. CODE OF 1954, § 336. However, depreciation recapture may be required by § 1245 or § 1250. See Part VII *infra*. *Y* corporation obtains an immediate cost basis for the *X* corporation stock equal to the full purchase price. See INT. REV. CODE OF 1954, § 1012. No gain is recognized to *Y* corporation upon receipt of the *X* assets as liquidating distributions. Recognition of gain is expressly precluded by § 332, but *Y* corporation would not have any gain upon the liquidation even in the absence of § 332, since *Y* corporation has a cost basis for the *X* corporation stock equal to the full purchase price.

summation of the transaction, the effect would be to leave 74 cents of each generated dollar for payment on the price of the *X* stock.

Obtaining an increased cash flow for purchasing corporation *Y* does not require exploitation of a tax loophole. One of the fundamental principles of our tax system is that every purchaser obtains a tax basis for acquired property equal to the purchase price, and he is entitled to recoup this basis in some way and at some time without payment of any tax. Under section 334(b)(2) of the Internal Revenue Code, the purchaser—corporation *Y*—obtains a basis for the former *X* assets equal to the purchase price which *Y* agrees to pay for the *X* stock, plus the liabilities of *X* assumed upon the liquidation of *X* into *Y*.[5]

The number of after-tax cents per dollar generated by the underlying assets will exceed the 48-cent minimum to the extent that corporation *Y* is able to correlate payments upon the purchase price with recoupment of the cost basis. A perfect correlation would result in 100 cents after taxes out of each dollar generated by the former *X* assets. Since depreciation is a primary method of basis recoupment, if all the assets acquired by corporation *Y* consisted of depreciable property, and if payment of the purchase price coincided exactly with the economic life of that depreciable property, there would be perfect correlation producing 100-cent dollars. The acme of 100-cent dollars is seldom, if ever, attained in a bootstrap sale, because not all the assets are depreciable, and because the seller desires payment as quickly as possible. It is possible, however, to approach the acme and substantially exceed the 48-cent minimum.[6]

2. *Tax Exempt Purchasers*

Tax exempt institutions have a competitive advantage in the bootstrap field if income generated by the underlying assets can be realized in a manner which avoids the tax imposed upon unrelated business income.[7] Rental from a lease for not more than five years is excluded from unrelated business income;[8] consequently, such

5. Treas. Reg. § 1.334-1(c)(4)(viii) (1955).

6. See Part IV *infra* for an example of sales where the acme of 100-cent dollars is achieved as a matter of course.

7. See INT. REV. CODE OF 1954, § 511.

8. Section 512(b)(3)-(4) of the Code excludes from unrelated business income all rental except that from business leases as defined in § 514. Section 514(b) defines a business lease as a lease for a term of more than five years if there is a business lease indebtedness with respect to the property. In a bootstrap purchase, there would be a business lease indebtedness, so the applicability of § 514 may be avoided by limiting the lease term to not more than five years.

leases are commonly used by tax exempt institutions in bootstrap transactions. Utilization of the rental exemption, however, requires modification of the standard bootstrap plan. Rather than operating the acquired assets, as in the case of the ordinary purchasing corporation, the tax exempt purchaser leases the assets to an operating company under a lease for not more than five years. The bootstrap attributes are retained, since no down payment is made except from the acquired assets, and liability for the purchase price is limited to the rental received.

To present an attractive bootstrap proposal, a tax exempt institution must receive at least 75 per cent of the income generated by the underlying corporate assets, particularly if the institution retains a portion of the income during the pay-out period. A formula which has been developed by certain institutions requires rental payments equal to 80 per cent of the operating company's net income. The institution retains 10 per cent of the rental and pays the remaining 90 per cent to the sellers for application upon the purchase price. This particular formula, which was employed in the Clay Brown transaction, produces 72 cents out of each dollar generated by the underlying corporate assets for payment upon the purchase price. The 72 cents is 90 per cent of the 80 cents received as rental by the tax exempt institution from each dollar realized by the operating company.

While the institute applies its tax exemption to the rental received under the five-year lease, it does not follow that all of the rental paid by the operating company to the tax exempt purchaser would incur a corporate tax if the institution were a tax paying entity. Every purchaser, irrespective of any tax exemption, receives a basis for the acquired assets equal to the purchase price. As reviewed above, tax-free recoupment of basis may produce after-tax results which substantially exceed the 48-cent minimum and approach the 100-cent ideal.

Since the purchase price in a bootstrap sale is dependent upon income generated by the underlying corporate assets, a prudent seller, as part of his security, insists upon managerial control until the purchase price has been paid. Such an arrangement is particularly necessary when the purchaser is not prepared to supply competent management. Ordinarily, a tax exempt purchaser does not provide management, so the operating company is managed by the person or persons who formerly managed the acquired corporation.[9]

9. In the *Clay Brown* case, the Tax Court classified the management contract be-

If the Clay Brown transaction had been handled under the standard bootstrap plan utilizing a business corporation rather than a tax exempt entity as purchaser, each dollar generated by the Clay Brown & Company assets would have left the following amounts per dollar after taxes available for payment upon the purchase price: 70 cents the first year, 67 cents the second year, 64 cents the third year, 62 cents the fourth year, and 60 cents the fifth year—an average of 65 cents for the five-year period.[10] Comparison of the 72-cent dollars produced by the Clay Brown transaction utilizing a tax exempt institution with the 65-cent dollars which could have been generated with the same assets under the standard bootstrap plan gives the transaction a complexion different from the pallor cast by a comparison of the Clay Brown results with the 14.4-cent dollars which would have been available to an individual purchaser.[11] Nevertheless, the Commissioner used hypothetical transactions producing 14.4-cent dollars as the norm for his comparisons. As the taxpayers asserted before the Supreme Court in *Clay Brown*, no one can be expected to buy a business with 14.4-cent dollars.

tween the seller, Clay Brown, and the operating company as a part of the security instruments. See Clay B. Brown, 37 T.C. 461, 483 (1961).

10. Computation of these percentages is set forth in the table below, which is based upon the following realistic assumptions: $1,000,000 of the purchase price for the Clay Brown & Company stock is allocated to depreciable property. In all probability, the sum of $1,170,000 could have been allocated to depreciable property and timber, so the $1,000,000 assumption is conservative. Rev. Proc. 62-2, 1962-2 Cum. Bull. 418, setting forth guidelines for depreciation, specifies a useful life of ten years for a sawmill and its equipment, the assets involved in *Clay Brown*. There is no salvage value required under these guidelines, since the period specified takes salvage value into account. That is, a ten-year useful life is the same as a nine-year useful life with 10% salvage. The declining-balance method of depreciation (1½ times) is used. Annual earnings of $350,000 before depreciation and taxes are also assumed.

	1st year	*2d year*	*3d year*	*4th year*	*5th year*
1. Earnings before depreciation	$350,000	$350,000	$350,000	$350,000	$350,000
2. Depreciation	150,000	127,500	108,375	92,120	78,305
3. Taxable income	200,000	222,500	241,625	257,880	271,695
4. Tax = 52%	104,000	115,700	125,645	134,100	141,280
5. Net Income	96,000	106,800	115,980	123,780	130,415
6. Add back depreciation	150,000	127,500	108,375	92,120	78,305
7. Cash flow	$246,000	$234,300	$224,355	$215,900	$208,720
Cents of cash flow per dollar generated (ratio between line 7 and line 1)	70.3	67.0	64.1	61.7	59.6

11. See text accompanying note 2 *supra*.

II. The Commissioner's Attack

In Revenue Ruling 54-420,[12] the Commissioner launched a three-pronged attack against bootstrap sales involving tax exempt institutions. One thrust of the attack denied capital-gain treatment to the sellers. Considerable litigation ensued, and the controversy eventually reached the Supreme Court in *Commissioner v. Clay Brown.* The particular facts of the case are concisely related in the Court's opinion.[13]

The Commissioner based his denial of capital-gain treatment solely upon the bootstrap attributes of the transaction. Whether the purchaser is a business corporation generating income from direct operation of the acquired assets, or whether the purchasing corporation is a tax exempt institution deriving income from a lease of the assets to an operating company, the bootstrap attributes are the same —payment of the purchase price is dependent upon income generated by the underlying assets and upon the assets themselves. Consequently, the Commissioner's attack in *Clay Brown* was not confined to sales involving tax exempt institutions, but rather was aimed at all bootstrap sales. In fact, the Commissioner's attack applied not

12. 1954-2 Cum. Bull. 128.

13. "The basic facts are undisputed. Clay Brown, members of his family and three other persons owned substantially all of the stock in Clay Brown and Company . . . . Clay Brown, the president of the company and spokesman for the group, was approached by a representative of California Institute for Cancer Research in 1952, and after considerable negotiation the stockholders agreed to sell their stock to the Institute for $1,300,000, payable $5,000 down from the assets of the company and the balance within 10 years from the earnings of the company's assets. It was provided that simultaneously with the transfer of the stock, the Institute would liquidate the company and lease its assets for five years to a new corporation, Fortuna Sawmills, Inc., formed and wholly owned by the attorneys for the sellers. Fortuna would pay to the Institute 80% of its operating profit without allowance for depreciation or taxes, and 90% of such payments would be paid over by the Institute to the selling stockholders to apply on the $1,300,000 note. This note was noninterest bearing, the Institute had no obligation to pay it except from the rental income and it was secured by mortgages and assignments of the assets transferred or leased to Fortuna. If the payments on the note failed to total $250,000 over any two consecutive years, the sellers could declare the entire balance of the note due and payable. The sellers were neither stockholders nor directors of Fortuna but it was provided that Clay Brown was to have a management contract with Fortuna at an annual salary and the right to name any successor manager if he himself resigned.

"The transaction was closed on February 4, 1953. Fortuna immediately took over operations of the business under its lease, on the same premises and with practically the same personnel which had been employed by Clay Brown and Company. Effective October 31, 1954, Clay Brown resigned as general manager of Fortuna and waived his right to name his successor. In 1957, because of a rapidly declining lumber market, Fortuna suffered severe reverses and its operations were terminated. Respondent sellers did not repossess the properties under their mortgages but agreed they should be sold by the Institute with the latter retaining 10% of the proceeds. Accordingly, the property was sold by the Institute for $300,000. The payments on the note from rentals and from the sale of the properties totaled $936,131.85." 380 U.S. at 566.

only to bootstrap sales of closely held corporations, but also to all other transfers for deferred payments contingent on future income. In a six-to-three decision, the Supreme Court rejected the Commissioner's contention that bootstrap attributes preclude compliance with the "sale" prerequisite for capital-gain treatment.

A. *Economic Substance of Bootstrap Sales*

No attempt was made by the taxpayers in *Clay Brown* to rely upon mere formulistic compliance with the "sale" prerequisite for capital-gain treatment. Similarly, the taxpayers did not minimize the bootstrap attributes of the transaction. They fully recognized that payment of the purchase price was completely dependent upon income generated by the underlying corporate assets and upon the assets themselves. No down payment was made from independent sources, and the Institute's liability to pay the purchase price was limited to income generated by the business. For economic substance, the taxpayers relied upon the substantial change of economic benefits which occurred despite the bootstrap attributes.

After a seller of stock in a bootstrap transaction executes the stock purchase agreement, each dollar paid to him from income generated by the underlying corporate assets is applied to the purchase price. When the sum of the payments equals the purchase price, all interest of the seller terminates, and the purchaser becomes the sole owner of the business. While payment of the purchase price in a bootstrap sale usually requires a number of years, a change in economic benefits occurs upon execution of the purchase agreement. Thereafter the seller has no alternative but to relinquish all rights when the purchase price has been paid. Each payment upon the purchase price made from income increases the equity of the purchaser and hastens the complete termination of the seller's interest. Only in the event of default will the seller recapture the property.

A bootstrap seller could well insist that all cash flow not needed in the business be devoted to payment of the purchase price. However, a less stringent requirement is imposed under transactions of the Clay Brown type. The tax exempt purchaser is entitled to retain ten per cent of the rental received from the operating company. In bootstrap sales not involving tax exempt institutions, the purchaser may also be allowed to use a small portion of cash flow for something other than payments upon the purchase price or capital improvements. Such interim enjoyment of a portion of the income permitted the purchaser during the pay-out period represents some

change in economic benefits, but the change which affords real economic substance is the potential termination of the seller's interest upon full payment of the purchase price and the emergence of the purchaser with free and clear title.

In the *Clay Brown* case, an effort was made by the Commissioner in the Tax Court to negate the change in economic benefit which resulted from the ability of the Institute to acquire the business free and clear upon payment of the purchase price. He contended that the Institute was never intended to be the ultimate owner of the business, since a tacit understanding existed between the parties which permitted the taxpayers to collapse the transaction and recapture the assets through an artificial triggering of a default. Substantiation of such a tacit understanding would have drained the transaction of economic substance.

To refute the Commissioner's contention that such a tacit understanding had been made by the parties, the taxpayers pointed to the extensive price negotiations and to the testimony of the Institute's president that the primary motivation of the Institute was the prospect of obtaining the assets free and clear after the purchase price had been fully paid, in order to convert the property into money for use in cancer research. If the Institute had never been intended to end up with a clear title to the assets, the extensive price negotiations were mere window dressing, and the president of the Institute was less than candid in his testimony concerning the primary motivation of the parties. In rejecting the Commissioner's contention, the Tax Court found that the price was the result of bona fide negotiations in an arm's-length transaction devoid of any plan or arrangement for artificially triggering a default.[14] The Tax Court further found that basic to the entire transaction was the taxpayer's obligation to relinquish all interest in the underlying corporate assets upon payment of the purchase price. In the opinion of the Tax Court, this change of interest constituted a real change of economic benefits.[15]

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14. "Upon consideration of all the evidence in this case we hold that the transaction constituted a bona fide sale by petitioners to the institute arrived at in arm's-length negotiations and devoid of any tacit understanding of the parties to collapse the deal at a time deemed appropriate by petitioners or of any plan or arrangement for artificially triggering a default." 37 T.C. at 486.

15. "Petitioners by the transaction here involved parted with their equitable ownership of the assets when they transferred the stock to the Institute. . . . This change of interest constitutes a change of economic benefits thus distinguishing this case from the cases relied on by respondent. In the present case the stock was transferred outright to the Institute and such transfer was basic to the entire transaction. . . ." *Id.* at 484.

Upon appeal to the Court of Appeals for the Ninth Circuit, the Commissioner abandoned his contention that there had been a tacit understanding between the parties, but he nevertheless asserted that the control exercised over the operation of the business by Clay Brown through his management contract permitted the taxpayers, as a practical matter, to cause a default and recapture the assets. However, the taxpayers pointed out that a purposefully induced default would violate the spirit, if not the letter, of the agreement and that tax consequences are not determined by rights which a party may exercise through breach of agreements.[16]

In the presentation before the Supreme Court, the Commissioner made no assertions militating against the fact that all the interest of the selling taxpayers would terminate upon full payment of the purchase price, and Mr. Justice White emphasized this point in the majority opinion.[17] Similarly, Mr. Justice Harlan, in his concurring opinion, stated that the taxpayers relinquished important rights as a result of the transaction and received something substantially different in return.[18]

B. *Risk-Shifting*

Ignoring any change in economic benefits resulting from the taxpayers' obligation to relinquish all interest upon payment of the purchase price, the Commissioner based his argument before the Supreme Court upon the lack of any risk-shifting after the execution of the purchase agreement. Since payment of the purchase price was dependent upon income generated by the underlying corporate assets, the taxpayers retained the risk of economic adversity. Having invested nothing and having assumed no personal liability, the Institute could lose nothing if the business were unable to pay the purchase price.

The taxpayers acknowledged their vital stake in the economic

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16. See 325 F.2d 313 (9th Cir. 1963).

17. See 380 U.S. at 569.

18. *Id.* at 580. In a vigorous dissent, Mr. Justice Goldberg stated: "Brown retained full control over the operation of the business; the risk of loss and the opportunity to profit from gain during the normal operation of the business shifted but slightly. If the operation lost money, Brown stood to lose; if it gained money, Brown stood to gain, for he would be paid off faster." *Id.* at 587. It is not clear why Mr. Justice Goldberg believed that "the opportunity to profit from gain during the normal operation of the business shifted but slightly," particularly since he stated that there would be a faster payoff if the operation gained money. The faster the payoff, the faster all rights of Brown would terminate, and the Institute would emerge with the property free and clear. This is something more than a slight shift of economic benefit. Perhaps the phrase "during the normal operation of the business" is meant to presume a purchase price which will require normal operations before payment is effectuated. If so, the statement is understandable, but the presumption concerning the purchase price finds no support in the *Clay Brown* facts.

welfare of the business until the purchase price was paid, but contended that, with respect to capital-gain treatment, the significance of risk-shifting is no greater than the consequences which may evolve from the lack of shift. In this regard, the only consequence which can result from the risk retained by a seller in a bootstrap sale is that he will receive something *less* than the agreed purchase price. As was asked by the taxpayers in their brief, why should the mere possibility that a seller might receive less than the agreed purchase price preclude capital-gain treatment for amounts actually received?[19] In what may become a classic statement in the area of capital-gains taxation, Mr. Justice White exposed the fallacy in the Commissioner's risk-shifting contention:

> To say that there is no sale because there is no risk-shifting and that there is no risk-shifting because the price to be paid is payable only from the income produced by the business sold, is very little different from saying that because business earnings are usually taxable as ordinary income, they are subject to the same tax when paid over as the purchase price of property. This argument has rationality but it places an unwarranted construction on the term "sale," is contrary to the policy of the capital gains provisions of the Internal Revenue Code, and has no support in the cases. We reject it.[20]

The Commissioner's argument concerning risk-shifting was also interspersed with frequent use of the term "transfer with income reserved." It was never made clear exactly what substantive support this term gave the risk-shifting argument, or how the lack of risk-shifting converted what would otherwise be a sale into a "transfer with income reserved." Neither the majority nor the concurring or dissenting opinions took cognizance of the term.

C. *Impact of the Purchase Price Upon Economic Substance*

Since the purchaser in a bootstrap transaction bears no risk of economic loss, he might content himself with the fringe benefits

19. As was further pointed out by the taxpayers in their brief, where persons purposefully transfer property for less than the acknowledged value at the time of the transfer, the existence of a sale has never been questioned. In such situations, the problem is one of how the transferee should account for the bargain portion of his "bargain purchase." If the purchaser is an employee, the bargain portion is compensation. Treas. Reg. § 1.61-2(d)(2) (1957). If the purchaser is a family member, the bargain portion is a gift. Treas. Reg. § 1.101-1(e) (1957).

20. 380 U.S. at 570. This statement is buttressed by the following quotation from Mr. Justice White's opinion: "To require a sale for tax purposes to be to a financially responsible buyer who undertakes to pay the purchase price from sources other than earnings of the assets sold or to make a substantial down payment seems to us at odds with commercial practice and common understanding of what constitutes a sale." *Id.* at 575.

accruing during the pay-out period (such as the ten per cent of the rental which the Institute was permitted to keep) and let the seller name his own purchase price. An unreasonably large purchase price could nullify the economic substance attributable to the termination of all the seller's interest upon full payment. Indeed, if the purchase price is so high that default and recapture of the assets are foregone conclusions at the time of transfer, there is no economic substance, and the transaction is a sham in the mold of *Kolkey v. Commissioner.*[21] Similarly, if it is reasonably certain at the time of transfer that the assets will be exhausted by the burden of paying the purchase price, the seller will have relinquished little or nothing by virtue of the agreement that the purchaser will end up with the assets free and clear upon payment of the price. Again, the transaction would lack economic substance.[22] In oral argument before the Supreme Court, the taxpayers acknowledged the potential abuses in bootstrap sales, and that such potential justifies scrutiny of the transaction by the trial court. However, the mere possibility of abuse furnishes no ground for an appellate court to disallow capital-gain treatment when the trial court has approved the bona fide nature of the transaction.

During the Tax Court hearing in *Clay Brown,* the Commissioner did not question the reasonableness of the purchase price. Although the Tax Court found that the price was the result of real negotiations arrived at in an arm's-length transaction and that the Institute was motivated by the primary objective of ending up with the assets free and clear,[23] such findings were not attributable to any challenge of the purchase price by the Commissioner. Rather, as previously related, such findings were made by the Tax Court in substantiation of the taxpayers' response to the Commissioner's assertion that, because of a tacit understanding which permitted the taxpayers

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21. 254 F.2d 51 (7th Cir. 1958).

22. See Part V *infra* for a discussion of the proposition that capital gain is not precluded by the transferor's ownership of stock in the transferee corporation. The right of the transferor to own stock in the transferee may confer as much control over the business as the ability to recapture the assets upon an inevitable foreclosure or to exhaust the assets in the process of paying the purchase price. Consequently, such economic substance may not be absolutely essential to capital-gain recognition, although it is most helpful.

23. The following quotations from the Tax Court's opinion are pertinent:

"The primary motivation of the institute . . . was the prospect of ending up with the assets free and clear after the purchase price had been fully paid, which would then permit the institute to convert the property into money for use in cancer research." 37 T.C. at 471.

"The price . . . was the result of real negotiating." *Id.* at 486.

"The finally agreed price was arrived at in an arms-length transaction . . . ." *Id.* at 488.

to recapture the assets through an artificial triggering of a default, the Institute was never intended to end up with the assets.

Perhaps all that is required by way of purchase price substantiation is a finding that the price resulted from real arm's-length negotiations with a properly motivated purchaser. However, the Tax Court went a step further in *Clay Brown* and found that the purchase price was within a reasonable range in light of the earnings history of the corporation and the adjusted net worth of the corporate assets.[24] This finding was volunteered by the Tax Court, possibly in response to the taxpayers' basic theme that there are no grounds for denying compliance with the sale prerequisite for capital-gain treatment if the purchase price is reasonable and the interest retained by the sellers for security purposes does not extend beyond the point of full payment of the purchase price.

In the Supreme Court, the Commissioner combined his risk-shifting argument with assertions concerning the absence of a realistic purchase price. According to the Commissioner, any bargaining in a bootstrap transaction is economically meaningless because of the lack of risk-shifting, and an excessive purchase price is inevitable. While Mr. Justice White recognized that there was some theoretical logic to this argument, he noted that it conflicted with the express finding of the Tax Court, supported by evidence in the record, that the purchase price was within reasonable limits based on the earnings and net worth of the company.[25] In addition, Mr. Justice White observed that if an excessive price is such an inevitable result of the lack of risk-shifting, it should be possible for the Commissioner to demonstrate that fact instead of failing to offer any evidence whatsoever on the point.[26]

III. Reasonable Approach to Purchase Price

A. *Judicial Suggestion for Modified Approach*

No tax abuses can arise from a bootstrap sale if the purchase price of the business is within a reasonable range of the value of the stock at the time of transfer, and if all interest of the seller terminates upon payment of the purchase price. The bootstrap attributes of such a transaction can only reduce the amount of capital-gain bene-

24. "The price of $1,300,000 (including the $125,000 of notes) was the result of real negotiating. It was within a reasonable range in the light of the earnings history of the corporation and the adjusted net worth of the corporate assets." *Id.* at 486.

25. 380 U.S. at 573.

26. *Ibid.*

fits by causing the seller to receive *less* than the reasonable value of the property. Assuming that all interest of the seller terminates upon payment of the purchase price, the primary problem in bootstrap sales, if one exists, is to police the amount of the purchase price. However, policing the purchase price should take a form other than denial of compliance with the "sale" prerequisite for capital-gain treatment, since this approach results in the taxation of all the gain as ordinary income, not merely the excessive portion.

The Supreme Court's opinion in *Clay Brown* extended to the Commissioner an invitation to modify his position. Mr. Justice White suggested that there are more precise approaches to the question of possibly excessive purchase prices, and further observed that the Commissioner's attack was a clear case of overkill.[27] Mr. Justice Harlan referred to the Commissioner's contention as an "all or nothing theory."[28]

The harshness of the Commissioner's "all or nothing" attack on bootstrap sales was particularly apparent in the *Clay Brown* case. Clay Brown & Company at the time of sale had a book net worth of $619,457, of which $448,471 constituted accumulated earnings upon which the corporate tax had been paid. With appraised values substituted for book figures, the reconstructed net worth of the company was $1,064,877. Moreover, a capitalization-of-earnings approach supports a value substantially in excess of $1,300,000, which was the agreed purchase price.[29] Even if the purchase price in *Clay Brown* had been $2,000,000, and $700,000 thereof were deemed excessive, why should *all* the gain be taxed as ordinary income, when a substantial portion of the assets represented accumulated earnings upon which the corporate tax had been paid? This, in turn, raises the question of what criteria should be used for determining the reasonable range of a purchase price and what tax consequences should result if the price exceeds the reasonable range but falls short of being so excessive as to nullify economic substance.

B. *Determination of a Reasonable Price Range*

Revenue Ruling 59-60,[30] supplemented by a vast body of case law, sets forth the approach, method, and factors to be considered in valuing, for estate and gift tax purposes, shares of stock in closely held corporations—the property most often sold in bootstrap trans-

27. *Id.* at 579.
28. *Id.* at 581.
29. See note 32 *infra.*
30. 1959-1 CUM. BULL. 237.

actions. If the purchase price in a bootstrap sale is no greater than the value that would be assigned under the criteria of Revenue Ruling 59-60, the price should be within a reasonable range.[31]

Under Revenue Ruling 59-60, primary consideration is accorded to earnings in the valuation of the stock of a closely held corporation such as Clay Brown & Company. It is clear from an analysis of the cases involving such a valuation through capitalization of earnings that the earnings record of Clay Brown & Company would have justified a price substantially in excess of the $1,300,000 actually set by the parties to the transaction.[32] The facility with which the criteria of Revenue Ruling 59-60 support the Clay Brown purchase price may account for the Commissioner's failure to raise the issue of reasonableness in the Tax Court.[33]

C. *Treatment of Excessive Portion*

What should be the tax consequence if the valuation criteria in Revenue Ruling 59-60, or other appropriate criteria, establish that a portion of the purchase price in a bootstrap sale is excessive? The answer is suggested by the manner in which the Commissioner treats sales between related parties, particularly sales between a

31. In Rev. Rul. 65-192, I.R.B. 1965-31, 10, the Commissioner announced that the general approach and methods of Rev. Rul. 59-60 are applicable to valuations of stock for income and other tax purposes as well as for estate and gift tax purposes. The "intrinsic value" determined by application of the approach and methods of Rev. Rul. 59-60 must not be confused with "fair market value" as the term is used in §§ 1001(b) or 301(b)(1)(A)—the price at which property would change hands between a willing buyer and seller under no compulsion to buy or sell and having reasonable knowledge of relevant facts. As illustrated by Andrew B. C. Dohrmann, 19 B.T.A. 507 (1930), and Champlin v. Commissioner, 7 F.2d 23 (10th Cir. 1934), stock may have substantial intrinsic value but no "fair market value" because there is no market where the holder can sell it for anything approaching its intrinsic value. John H. Altorfer, T.C. Mem. 1961-48, held that the "willing seller" concept causes property to lack a fair market value when no one will pay what the seller considers a fair price.

If the owner of a closely held corporation could make a cash sale at the value determined through the general approach of Rev. Rul. 59-60, he would not consider a bootstrap sale. The primary motivation of bootstrap sales is the inability to find a purchaser willing to pay cash equal to the value determined by the methods of Rev. Rul. 59-60.

32. Clay Brown & Company had annual earnings of $339,000 prior to the sale. The earnings rate used in valuing stock under the capitalization-of-earnings approach generally varies from 6% to 10%. See Florence M. Harrison, 17 T.C.M. 776 (1958).

An earnings rate of 6% indicates a value of $5,650,000 for the Clay Brown & Company stock, and an earnings rate of 10% gives a value of $3,390,000. With an earnings rate of 15%, a high rate the Commissioner seldom if ever uses, the value of the Clay Brown & Company stock would be approximately $2,200,000.

33. It is doubtful that the purchase price in any transaction employing the mechanics of the Clay Brown sale would be excessive, since the five-year limitation upon leases which the charity could make and still receive the rental tax free means that the earnings of the corporation must be sufficient to permit payment of the purchase price within the five-year period. A purchase price which can be paid out in five years from earnings will ordinarily support a substantially higher value under the criteria of Revenue Ruling 59-60.

principal stockholder and his corporation, where hard bargaining is not expected. There is at least as much chance of an excessive purchase price in such transactions as in the case of bootstrap sales. However, if the price is excessive in a sale between a principal stockholder and his corporation, the Commissioner taxes only the excessive portion as ordinary income, permitting capital-gain treatment for the remainder.

Taxing only the excessive portion as ordinary income fits the penalty to the alleged rule infraction. An example of fitting the penalty to the infraction is found in *Roy G. Champayne*.[34] This is one of the cases cited in Revenue Ruling 58-353,[35] which confirms capital-gain treatment under the general capital-gain provisions for transfers of all rights in a patent. The patent transfer in the *Champayne* case was between a majority stockholder and his corporation. Because of the relationship between the parties, the court gave the transaction special scrutiny, which resulted in a determination that a portion of the consideration was excessive. However, only the excessive portion was taxed as ordinary income, and capital gain treatment was accorded the remainder. A similar approach was taken by the Tax Court in the recent case of *Arthur M. Rosenthal*,[36] involving the sale of buildings to a corporation controlled by the seller. The court held that there was a valid sale to the extent of the fair market value of the properties, but that the excessive portion of the consideration should be treated as disguised dividends to the extent of the corporation's earnings and profits.

The presence of bootstrap attributes may call for the same scrutiny as do sales between majority stockholders and their corporations. The dividend rationale of the *Rosenthal* case is used by the Commissioner to tax as ordinary income the excessive portion of the purchase price in sales between such related parties. While the dividend rationale is not available in a bootstrap sale, there should be another, similar rationale to justify this modified approach. Capital-gain benefits apply to proceeds from the sale of capital assets, and amounts in excess of the value of such assets at the time of transfer represent something other than the proceeds from the sale of capital assets.

The lack of a rationale for taxing only the excessive portion of the purchase price as ordinary income did not account for the Commissioner's disinclination to pursue this modified approach in *Clay*

34. 26 T.C. 634 (1956).
35. Rev. Rul. 58-353, 1958-2 CUM. BULL. 408.
36. P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65254 (Oct. 1, 1965).

Brown. During Tax Court preparations, the taxpayers in *Clay Brown* offered to stipulate that any portion of the purchase price found by the court to be excessive should be taxed as ordinary income, if the Commissioner would stipulate that the reasonable portion was entitled to capital-gain treatment. The Commissioner declined this proposal.

The Commissioner has announced in TIR-768[37] that the *Clay Brown* decision does not extend to cases where the amount payable to the seller exceeds the fair market value of the stock at the time of transfer. In such cases the Commissioner will continue to resist what he considers an attempt to convert future business profit into capital gain. It is not clear whether the Commissioner will treat only the excessive portion of the purchase price as future business profits, or whether he will revert to his "all or nothing" approach.

IV. The Commissioner's Attack Extended Beyond Bootstrap Sales

The purchase price in a bootstrap sale is a fixed amount. In a different type of sale, the amount of the purchase price is measured by future income generated by the transferee's use of the property. When the amount of the purchase price is *measured* by future income, payment of the purchase price is necessarily dependent thereon. The following is a typical transaction in this contingent-price category: *S*, owner of a patent which he purchased from the inventor, grants all rights in the patent to *P* in consideration of *P*'s agreement to pay *S* a specified percentage of the net profit or gross receipts realized by *P* from his exploitation of the patent during its full remaining life. The arrangement permits *S* to terminate the rights of *P* upon failure of *P* to pay specified minimum amounts.

A long line of authorities sustains capital-gain treatment for amounts received by *S* in the above illustration.[38] Such transactions are classic examples of transfers for a consideration dependent upon future income. Since dependency upon future income was the basis of the Commissioner's argument for denying capital-gain treatment

37. TIR-768, Oct. 1, 1965.

38. See cases cited in Rev. Rul. 58-353, 1958-2 Cum. Bull. 408. Section 1235 applies to the sale or exchange of patents by the inventor or any other individual who has acquired his interest in the patent for consideration paid to the inventor prior to actual use of the patent. Thus, the transaction depicted in the above illustration is beyond the scope of § 1235, because *S* was not the inventor and did not obtain his interest through consideration paid to the inventor prior to the actual reduction to practice. As indicated by the cases cited in Rev. Rul. 58-353, *supra*, § 1235 is not deemed exclusive, and failure to come within § 1235 does not preclude capital-gain recognition under the general capital-gain provisions.

in *Clay Brown,* he could not ignore these common patent-transfer arrangements. However, his problem was compounded by Revenue Ruling 58-353,[39] in which he had expressly confirmed capital-gain treatment for such transfers.

Unable to reconcile the contingent-price patent transfers with his assertion in *Clay Brown* that there is no compliance with the "sale" prerequisite for capital-gain treatment when payment of the purchase price is dependent upon future income generated by the transferred property, the Commissioner boldly asserted that all the cases according capital-gain treatment to patent transfers were incorrect and that the courts which had rendered those decisions had been unduly preoccupied with legalistic property concepts. The only reference to Revenue Ruling 58-353 was in a footnote of the Commissioner's brief, where it was claimed that the ruling was issued merely to stem an increasing tide of adverse court decisions "at least for the time being."

The shift of economic benefits is not the same in a contingent-price patent transfer as in a bootstrap sale. In patent transfers, the seller and the purchaser share proportionately in the income generated by the patent over its full useful life. There is not the possibility of disproportionate benefits that there is in the case of bootstrap sales, where all, or substantially all, of the income goes to the seller until the purchase price has been paid, and thereafter all of the income, as well as the property itself, belongs to the purchaser free from any further claims of the seller.[40] As noted by Mr. Justice White, even if the Commissioner were correct in his contention that the decisions which allow capital-gain treatment for contingent-price patent transfers were erroneous, it would not follow that capital-gain recognition should likewise be denied in bootstrap sales.[41]

Not only do the contingent-price patent transfers covered by

39. 1958-2 CUM. BULL. 408.

40. In a contingent-price transfer, the measure of value is a percentage of future income, while in a bootstrap transaction the measure of value is a fixed price. In a fixed-price bootstrap transaction, all, or substantially all, of the income generated by the transferred assets is devoted to payment of the purchase price. In a contingent-price transfer, the percentage of income devoted to payment of the purchase price is usually a minor fraction, although there may be transactions where there is business purpose and economic substance if the purchaser agrees to pay the seller all profits and income realized by the purchaser from the acquired property. Contingent prices measure value where it is difficult to fix value in terms of a flat amount. For example, a patentable invention must embody a "flash of genius." How can one measure the value of such a device prior to ascertaining its commercial feasibility? Similarly, there are situations other than patent sales where contingent prices are used. See, *e.g.,* Burnet v. Logan, 283 U.S. 404 (1931); Cassatt v. Commissioner, 137 F.2d 745 (3d Cir. 1943); Estate of Raymond T. Marshall, 20 T.C. 979 (1953).

41. See 380 U.S. at 577 n.8.

Revenue Ruling 58-353 represent classic examples of consideration dependent upon future income from the property transferred; such transfers are also classic examples of an exact correlation between the recoupment of tax basis and payments upon the purchase price. As previously mentioned, the acme of 100-cent dollars is seldom obtained in bootstrap sales. However, this result is achieved as a matter of course in contingent-price sales of patents, since the exact amounts paid to the transferor are deductible as depreciation by the transferee. The right of the patent transferee to deduct the payments in full as depreciation is confirmed by the Commissioner's published acquiescence in *Associated Patentees, Inc.*[42] Since the overall tax benefits sought in bootstrap sales are less than the tax benefits routinely attained in contingent-price patent transfers, the Commissioner undoubtedly would have changed Revenue Ruling 58-353 if the Supreme Court had substantiated his contentions in *Clay Brown.*

V. Effect of Seller's Ownership of Stock in Purchaser

In a standard bootstrap transaction, one or more of the selling stockholders may own, or desire to own, stock of the purchasing corporation. A pertinent inquiry is whether such an arrangement will jeopardize capital-gain treatment.

As a general proposition, capital-gain benefits are not precluded by the transferor's ownership of stock in the transferee corporation, since a corporation is a taxable entity separate from the stockholders. If it were not for the express provisions of section 351 of the Internal Revenue Code, a person would realize gain when he receives stock or other securities from his wholly owned corporation in exchange for property which has appreciated in value. The character of the gain—capital or non-capital—is unaffected by the transferor's control of the transferee corporation, unless a contrary conclusion is dictated by express Code provisions, such as section 1239. Under section 1239, ordinary-income treatment is required for gain realized upon the sale of depreciable property between an individual and a corporation in which the individual owns more than eighty per cent of the stock. This amounts to statutory recognition that capital-gain treatment is allowed upon the sale of depreciable property by an individual to a corporation in which he owns *up to* eighty per cent of the stock. In situations where the property is not depreciable, capital-gain treatment is allowed even though the seller owns all of the stock of the purchasing corporation.

42. 4 T.C. 979 (1945), *acq.*, 1959-2 Cum. Bull. 3.

A person who owns eighty per cent of the stock of the purchasing corporation not only retains an indirect beneficial interest in the transferred property, but also has the ability to acquire a direct interest through the simple expediency of liquidating the corporation. Furthermore, an individual who owns eighty per cent (or even fifty-one per cent) of the stock of the purchasing corporation may exercise greater control over the corporation's operations than is possible through a management contract such as that between Clay Brown and the operating company.[43]

Although capital-gain treatment is not precluded by the transferor's stock ownership in the transferee corporation unless an applicable Code provision dictates otherwise, the Commissioner is quick to find statutory provisions which he believes alter the general proposition. A bootstrap sale under the standard plan involves the transfer of property between two corporations and the payment from earnings of the purchasing corporation to the former stockholders of the corporation which has been sold. Nothing more is needed for the Commissioner to assert the existence of a reorganization as defined in section 368 of the Internal Revenue Code. His purpose in finding such a reorganization is to invoke section 356(a)(2), which, if applicable, permits taxation of the purchase-price payments as dividends.[44]

Where the selling stockholders own eighty per cent or more of the stock of the purchasing corporation, the Commissioner might

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43. In his Supreme Court presentation, the Commissioner did not stress the control exercisable by Clay Brown over the operating company as a ground for denying capital-gain treatment. Nevertheless, control over assets generating payment of the purchase price is a cornerstone of Mr. Justice Goldberg's dissent. Limitation of the purchaser's liability to income generated by the acquired property (and the property itself) would not cause negation of a sale, under the dissenting view. Statements made by Mr. Justice Goldberg during oral argument indicated that he was aware that 100% financing occurred in the business world. It is only when such limitation of liability is combined with control over the operation that the dissenting Justices would deny capital-gain treatment. In addition to emphasizing the control feature, the dissent expressed considerable doubt concerning the propriety of tax exempt institutions participating in bootstrap transactions. If the transaction involved in *Clay Brown* had been a standard bootstrap sale where the purchaser, a business corporation, supplied the management, there would have been no dissent, even though payment of the purchase price were limited to income generated by the transferred business and the assets thereof. The only question is how the dissent would regard: (1) a standard bootstrap transaction not involving a tax exempt charity where the seller controls management during the payout period, or (2) a bootstrap sale utilizing a tax exempt charity where the seller divorces himself from all control over the operation.

44. See Moore, *Taxation of Distributions Made in Connection With a Corporate Reorganization*, 17 TAX L. REV. 129 (1961); Nicholson, *Recent Developments in the Reincorporation Area*, 19 TAX L. REV. 123 (1964). As discussed in note 45 *infra*, it is doubtful that § 356(a)(2) applies to payments made from profits earned after the purchase.

assert the existence of a section 368(a)(1)(D) reorganization, using the rationale employed in the liquidation-reincorporation area.[45] If the selling stockholders do not own eighty per cent of the stock of the purchasing corporation, there is no possibility of a clause D reorganization. However, the Commissioner may nevertheless claim a clause E or F reorganization, as he has done under the liquidation-reincorporation doctrine even when the stockholders of the transferor corporation own less than fifty per cent of the stock of the transferee corporation.[46] When the stock ownership of the selling

45. A bootstrap transaction under the standard plan has never been involved in a case where the Commissioner has asserted a reorganization. However, the Commissioner has successfully asserted a clause (D) reorganization in situations involving § 337. Cases in this and related fields are discussed in the articles cited in note 44 *supra*. Cases decided since the publication of these two articles where the Commissioner has established the existence of a dividend based on a clause (D) reorganization are: South Texas Rice Warehouse Co., 43 T.C. 540 (1965); James Armour, Inc., 43 T.C. 295 (1964); Harry Trotz, 43 T.C. 127 (1964); Reef Corp., P-H 1965 TAX CT. REP. & MEM. DEC. ¶ 65072 (April 9, 1965).

In the cases involving § 337, the distributions taxed as dividends were those made upon liquidation of the acquired corporation. In these § 337 transactions, the acquiring corporation purchases the assets of the acquired corporation, which is liquidated with its remaining assets (including the purchase price received upon the sale to the purchaser) being distributed to the stockholders upon such liquidation. If the purchase price is payable on a deferred-payment basis, the deferred-payment obligation is distributed to the stockholders of the acquired corporation upon its liquidation, together with the other assets.

In a bootstrap transaction under the standard plan, the liquidating distributions are received by the acquiring corporation, not the stockholders of the acquired corporation. A portion of the cash received by the acquiring corporation upon the liquidation of the acquired corporation may be paid as an initial installment upon the purchase price for the stock of the acquired corporation. Even if a bootstrap sale under the standard plan is deemed to be a reorganization, can the initial payment made by the purchasing corporation from assets received upon liquidation of the acquired corporation be taxed as a dividend under § 356(a)(2)? In most bootstrap sales, this problem would not be particularly acute since the initial payment is usually small, practically all of the purchase price being paid from cash flow generated by the purchasing corporation's operation of the underlying assets.

The more important problem is whether there is any basis for taxing as a dividend *subsequent* purchase price payments made by the purchasing corporation from income generated by its operation of the underlying assets. Can payments from profits earned by the acquiring corporation *after* the stock transfer and *after* liquidation of the acquired corporation into the acquiring corporation be considered as cash "boot" within the coverage of § 356(a)(2), such coverage being necessary before the Commissioner can sustain a dividend assertion? Existence of a reorganization does not assure the applicability of § 356(a)(2), although the provision cannot apply unless there is a reorganization. There are effective arguments which can be made in opposition to the applicability of § 356(a)(2) if the Commissioner should rely upon it in a bootstrap sale under the standard plan. However, rather than relying upon the non-applicability of § 356(a)(2) if there is a reorganization, it is better to avoid coverage of the reorganization provisions. A clause D reorganization is avoided if stockholders of the sold corporation own less than 80% of the stock of the purchasing corporation. The assertion of a clause D reorganization has been the Commissioner's main weapon in the liquidation-reorganization area.

46. See Rev. Rul. 61-156, 1961-2 CUM. BULL. 62. However, the Commissioner has met with little success in urging a clause E or F reorganization where former stockholders of the acquired corporation own less than 80% of the stock of the acquiring corporation. The Tax Court rejected the Commissioner's contentions in Hyman H.

stockholders in the purchasing corporation exceeds, or even approaches, fifty per cent, such ownership should be justified by sound business reasons other than the desire to obtain capital-gain benefits.[47]

VI. Comparison With Stock Redemptions

In a bootstrap sale of a closely held corporation, the transferor may have a right to the underlying corporate assets and the cash flow from them to enforce payment of the purchase price. If a transferor is entitled to only the corporate surplus to enforce payment, the label "bootstrap" may be overly strong. Perhaps the term "shoestring" is appropriate to denote a transaction in which the transferor has less claim upon the underlying corporate assets than the transferor in a bootstrap transaction.

A typical stock redemption would represent a "shoestring" transaction. In such a case, corporation *X* redeems all the stock of majority stockholder *S* for a fixed redemption price payable over a period of years. Under the corporation laws of most states, stock can be redeemed only out of surplus.[48] Mr. Justice Harlan's terse observation in the first sentence of his concurring opinion in *Clay Brown* applies with equal force to such a stock redemption: "Were it not for the tax laws, the . . . transaction . . . would make no sense."[49] In a tax-free society, *S* could receive his share of the earnings and surplus indefinitely without limitation, and there would be no reason for him to give up his stock interest when payments from earnings and surplus aggregate a specified sum.

How strong is the bargaining position of corporation *X* when it negotiates the redemption price for the stock of controlling stockholder *S*? Could a court find that the redemption price results from real negotiations in an arm's-length transaction, as did the Tax Court in *Clay Brown?* It seems just as accurate to say that an excessive purchase price is inevitable in a stock redemption as in the case of a bootstrap sale. However, allowance of capital-gain treat-

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Berghash, 43 T.C. 743 (1965); Book Production Indus., Inc., P-H 1965 Tax Ct. Rep. & Mem. Dec. ¶ 65065 (April 2, 1965). In Pridemark, Inc., 42 T.C. 510 (1964), the Tax Court sustained the Commissioner's assertion of a clause F reorganization, but its decision was reversed on appeal. See Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965).

47. A strong business purpose was emphasized by the Tax Court when it rejected the Commissioner's asserted reorganization in Joseph C. Gallagher, 39 T.C. 144 (1962). In that case the stockholders owned 38% of the stock of the acquired corporation and 73% of the stock of the acquiring corporation. Business purpose was also emphasized in Hyman H. Berghash, 43 T.C. 743 (1965), where the sole stockholder of the acquired corporation owned 50% of the stock of the acquiring corporation.

48. For a discussion of the problems in this area, see Herwitz, *Installment Repurchase of Stock: Surplus Limitations*, 79 Harv. L. Rev. 303 (1965).

49. 380 U.S. at 579.

ment for stock redemptions is imbedded in the tax law through section 302 of the Code and related cases. There has been no suggestion that capital-gain benefits are jeopardized by dependency of the redemption price upon the underlying corporate assets. Yet, such dependency is inherent in stock redemptions.[50]

There is a good reason why a stockholder will permit redemption of his stock from corporate assets without demanding an excessive price. Redemption proceeds are entitled to capital-gain treatment, while most other corporate withdrawals are taxed as ordinary income. The rationality of such transactions was perceived by Mr. Justice Harlan in his concurring opinion in the *Clay Brown* case. After relating that the transaction would make no sense if it were not for the tax laws, Mr. Justice Harlan observed that the tax laws exist as an economic reality in the businessman's world, much like the existence of a competitor, and businessmen plan their affairs around both. The fact that a transaction is tax-motivated does not mean it lacks economic substance. The economic substance of a stock redemption is the elimination or substantial reduction of the stockholder's interest in the corporation. Such is the thesis of section 302.

From the standpoint of risk-shifting, a bootstrap seller retains less risk than a stockholder who has his stock redeemed for a redemption price payable over a period of years. A redemption does not increase the cash flow of the redeeming corporation, even though the redemption price substantially exceeds book value. The redeeming corporation obtains no step-up in basis for the corporate assets to which the stockholder must look for payment of the redemption price. In a bootstrap sale, the purchasing corporation receives a tax basis for the corporate assets commensurate with the purchase price, thereby increasing the cash flow emanating from the assets to which the seller must look for payment of the purchase price.

VII. Impact of Depreciation Recapture Under Sections 1245 and 1250

One benefit which a bootstrap purchaser can offer a prospective seller is the increased cash flow available to the purchasing corporation. The primary source of such increased cash flow is the step-up in basis for the depreciable assets under section 334(b)(2) of the Code, which permits the purchasing corporation to allocate among

50. The redeemed stockholder may continue as an officer, director, or employee of the redeeming corporation if he has no relationship to the other stockholders under the attribution rules of § 318(a).

the acquired assets the purchase price of the stock and the liabilities assumed. Prior to the enactment of sections 1245 and 1250, the step-up in basis could be accomplished without any corresponding gain or other tax detriment to the acquired corporation upon its liquidation into the purchasing corporation.

Section 1245 applies to personal property such as machinery and equipment, and section 1250 applies to buildings.[51] Under section 1245, the full step-up in basis of the machinery and equipment is taxed as ordinary income to the extent of depreciation taken after December 31, 1961. Section 1250 applies to depreciation taken after December 31, 1963, and the depreciation recapture varies with the length of time that the building has been owned, starting with full recapture during the first year and ending with no recapture after the tenth year.

The event in a bootstrap transaction which triggers the applicability of section 1245 or section 1250 is the distribution of the property by the acquired corporation to the purchasing corporation upon the liquidation of the acquired corporation into the purchasing corporation. Applicability of section 1245 or section 1250 is not precluded if the purchaser is a tax exempt institution. The depreciation recapture is incurred by the distributing corporation, and a tax exempt institution would inherit the liability as transferee to the same extent as a non-tax exempt purchaser.

While sections 1245 and 1250 are applicable to bootstrap sales only to the same extent as to other sales, the impact of these provisions upon bootstrap transactions is particularly severe, since the tax costs of the depreciation recapture may, to a considerable extent, counteract the additional depreciation available to the purchasing corporation. As pointed out to the Supreme Court in *Clay Brown*, bootstrap sales may be relics of a bygone era due to the effect of section 1245. Therefore, substantiation of the Commissioner's position was not required to deal with an acute currently existing problem.

Sections 1245 and 1250 do not apply to tax-free transactions such as transfers of assets in connection with reorganizations as defined in section 368, or to liquidations of subsidiaries under section 332 if section 334(b)(2) is not applicable. The advantages of avoiding the impact of sections 1245 and 1250 may outweigh the benefits of obtaining a step-up in basis, thereby changing the ground rules for corporate sales. Previously, purchasers of corporations attempted to avoid the reorganization provisions of the Code because

51. See generally Branda, *Problems in Recapture of Depreciation*, PROCEEDINGS OF N.Y.U. 23d ANNUAL INST. ON FED. TAX. 449 (1965).

of the dividend problems discussed earlier. Moreover, the reorganization provisions provide for a carryover basis for the assets rather than a step-up in basis requisite to increased depreciation and cash flow. Currently, means may be sought to accomplish corporate buy-outs under the provisions for tax free reorganizations even where the purchase price is payable over a period of years.[52] Perhaps the next tax frontier in the corporate buy-out field will be the development of a plan which will permit a bootstrap transaction without causing depreciation recapture under section 1245 or section 1250.[53]

VIII. Deductibility of Rent by Operating Company

In another thrust of the three-pronged attack upon bootstrap sales involving tax exempt institutions, the Commissioner challenged the ability of the operating companies to deduct the rent payments for income tax purposes. This issue was not involved in the *Clay Brown* case, but the function of the operating company is such an integral part of such transactions that the favorable opinion of the Supreme Court in *Clay Brown* should have some impact upon the Commissioner's claims regarding the deductibility of the rent as a business expense by the operating companies.

Decisions of the Tax Court on the issue of rentals have varied. In *Anderson Dairy, Inc.*,[54] the first decision on the question, the Tax Court sustained the right of the operating company to deduct the full amount of the rental paid to the tax exempt lessor. The decision was based on the fact that the lessor and the operating company were unrelated parties, and the Internal Revenue Code does not limit deductions for rental payments to a "reasonable

52. However, one obstacle is the "continuity of interest" requirement. If the stockholders of the acquired corporation received only debt obligations of the acquiring corporation, the necessary continuity of interest would be lacking. Even if there were a reorganization, the receipt of debt obligations for stock would result in the taxation of these securities as "boot" under § 356. Perhaps preferred stock could be used in the place of debt obligations. While the requisite continuity of interest must be represented by stock, it need not be voting stock. See 3 Mertens, Federal Income Taxation § 20.59, at 223 (1942); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 Harv. L. Rev. 1183 (1957).

53. The impact of §§ 1245 and 1250 may result in greater use of stock redemptions for accomplishing corporate buy-outs along the lines utilized in Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (approved by the Commissioner in Rev. Rul. 55-745, 1955-2 Cum. Bull. 223). In *Zenz*, a sole stockholder of a corporation sold part of her stock to a purchaser, and shortly thereafter had the remainder of her stock redeemed by the corporation for an amount equal to the corporation's earned surplus. It may be possible to adapt this approach to bootstrap acquisitions by having the purchaser acquire a small portion of the stock from the selling stockholder and then have the corporation redeem all the remaining stock of the selling stockholder for a redemption price payable over a period of years from the earnings of the corporation. However, in bootstrap sales, one must also consider the impact of the interest imputation provisions of § 483.

54. 39 T.C. 1027 (1963).

allowance" as in the case of salary or other compensation. Similar conclusions were reached in *Isis Windows, Inc.*[55] and *Oscar C. Stahl.*[56]

In *Royal Farms Dairy Co.*[57] and *Estate of Sol Goldenberg,*[58] the Tax Court reduced the deductible rental from eighty per cent of net income as provided under the leases to fifty per cent and fifty-five per cent respectively. The grounds for these decisions were findings that, although the rental amounts were part of the standard formula used by tax exempt institutions in such transactions, the purpose of these two rental arrangements was to give the lessors funds with which to pay the purchase price of the stock. According to the Tax Court, this, together with lack of substantial negotiations between the lessor and the operating company, militated against the argument that the rental was required as a condition to the operating company's use of the leased property.

When the full background of rental formulas is understood, standardization of the rental provision supports rather than refutes the conclusion that the operating company had no alternative but to accept the formula if it desired to participate in the transaction. The tax exempt purchaser must obtain approximately eighty per cent of the income generated by the underlying corporate assets if it is to enjoy a competitive advantage over bootstrap propositions, which could be offered under the standard plan not involving tax exempt institutions.[59] Why should the operating company engage in futile negotiations for a lower percentage, particularly if the eighty per cent figure is also attractive from the lessee's viewpoint? An opportunity to obtain the use of all the assets of a going business for an obligation to pay eighty per cent of the generated income is most appealing to a prospective lessee. The lack of liability for rental if no income is realized warrants a limitation of the lessee's share of profits to twenty per cent. Is there any better example of a fair rental rate than one which not only satisfies the lessor's requirements for obtaining funds with which to pay the purchase price for the leased assets, but is also attractive to the lessee?

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55. 32 P-H Tax Ct. Mem. ¶ 63176 (1963).

56. 32 P-H Tax Ct. Mem. ¶ 63201 (1963).

57. 40 T.C. 172 (1963).

58. P-H 1964 TAX CT. REP. & MEM. DEC. ¶ 64134 (1964).

59. Rental of 60% of net income would leave only 54 cents out of each generated dollar for payment upon the purchase price if the tax exempt purchaser retained 10% of the rental. Fifty-four cents is only slightly higher than the 48-cent minimum obtainable under the standard bootstrap plan. Rental of 70% of net income would leave 63 cents out of each generated dollar for payment upon the purchase price. As previously discussed in note 9 *supra* and accompanying text, handling of the Clay Brown transaction under the standard plan would have produced an average of 65 cents over the 5-year period.

Operating companies in transactions of the Clay Brown type must accept the eighty per cent rental formula if they desire to participate. The only question is whether the required payment of eighty per cent of net income is rental, or payments in a joint undertaking to supply the lessor with the required funds.[60] Regardless of how the payments are labeled, the operating company should not be taxed with income which the company was required to relinquish as a condition to participation in the transaction.

IX. Summary and Conclusion

On the basis of only a casual observation, transactions of the Clay Brown type may appear to have the aura of tax avoidance schemes lacking in economic substance. However, they are actually sheep in wolves' clothing. The Commissioner used the off-beat trappings as the occasion for launching an attack which, if successful, would have created an open season for sheep previously considered secure in the capital-gain sanctuary. The Supreme Court detected the true nature of the animal despite the Commissioner's loud cries of "wolf."

In *Clay Brown,* the Supreme Court sustained the tax cornerstone of bootstrap sales by holding that capital-gain treatment is not precluded merely because payment of the purchase price is wholly dependent upon cash flow generated by the transferred property and upon the property itself. Such capital-gain benefits are available even though the seller manages the property during the pay-out period. This holding is supported by economic substance attributable to the obligation of the seller to relinquish all interest in the transferred property upon full payment of the purchase price.

Economic substance may be lacking when the purchase price is so high as to make it obvious at the time of transfer that the parties contemplate a default which will permit the seller to recapture the assets. Similarly, the price may be so high as to make it clear at the time of transfer that the assets will be completely exhausted in the process of paying the purchase price.[61] If the purchase price is not sufficiently high to vitiate the economic substance of a transaction,

60. Present indications are that the Commissioner will concentrate on the joint undertaking or joint venture approach against the charitable institutions. This will terminate his campaign against the operating companies. The Tax Court case involving Fortuna Sawmills, Inc. (the operating company in Clay Brown) was on the February Portland, Oregon calendar of the Tax Court. Pursuant to the request of counsel for the Commissioner, the hearing was postponed until the Commissioner has made a definite decision concerning his position.

61. See the discussion in note 22 *supra* dealing with the issue of whether this lack of economic substance would actually negate capital-gain treatment.

but it nevertheless exceeds a reasonable range, the door is left open for the Commissioner to tax the excessive portion as ordinary income.

The *Clay Brown* decision was not a defeat for the Commissioner which will open the floodgates of tax avoidance. It was merely a judicial admonition to correlate his assertions with economic reality. There simply is nothing wrong with a bootstrap sale where the purchase price is reasonable and the seller is obligated to relinquish all rights to the purchaser upon full payment of the purchase price. Ordinary income is not converted into capital gain when a reasonable purchase price is payable from cash flow generated by the underlying corporate assets.

If the Supreme Court had adopted the Commissioner's contention of "no sale" unless there is a substantial down payment from independent sources or meaningful personal liability, how large should the down payment be and how much financial affluence must the purchaser possess to assure capital gain treatment for the seller? The Commissioner made it clear in his Supreme Court brief that these were questions of degree, requiring judgment based on all the circumstances.[62] Such an unsettled state of affairs would militate against *any* deferred-payment sale, since a seller would run a risk as to whether the size of the down payment or financial affluence of the purchaser fell within or beyond the shadowy boundary line.

Under the Commissioner's assertions, only the financially affluent would be capable of assuring capital-gain benefits for a seller. In the past, however, bootstrap purchases have been a primary method for attaining financial affluence. Considerable romance would depart from the American economic scene if the "have nots" could not compete with the "haves" for the purchase of businesses. Whether tax exempt institutions should share in the romance is a separate question, but the Commissioner did not restrict his attack in *Clay Brown* to transactions involving tax exempt institutions. He asked the Court to sound the death knell for all bootstrap sales. The Supreme Court rejected the Commissioner's sweeping assertions, and it is hoped that Congress will exercise the same discretion, regardless of what may be done in regard to bootstrap participation of charitable institutions or loss corporations.

62. "It hardly needs adding that whether any given down payment or pledge of other assets or of personal liability is sufficient to qualify a particular transaction as a sale is, of course, a question of degree, requiring a judgment based upon all the circumstances bearing on the extent to which there has been a significant shift of the risks. The judgment would have to take into account, for example, not only the absolute amount of the down payment or its relationship to the price but also such factors as the speculative or stable nature of the asset . . . ." Brief for Appellant, p. 58, Commissioner v. Clay Brown, 380 U.S. 563 (1965).