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TAXATION-FEDERAL INCOME TAX-TAX AVOIDANCE BY USE OF PREFERRED STOCK "BAIL-OUT"

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TAXATION—FEDERAL INCOME TAX—TAX AVOIDANCE BY USE OF PREFERRED STOCK "BAIL-OUT"—In 1946 petitioner received a pro-rata dividend of preferred stock of the distributing corporation, paid on its voting common, the only class of stock then outstanding. The dividend stock was immediately sold to certain insurance companies pursuant to prior informal agreements between the insurance companies, the corporation, and the shareholders.[1] Provision was made for the mandatory redemption of the preferred stock over a period of eight years. The transactions were the culmination of a series of negotiations intended to eliminate the large accumulated surplus of the corporation, in order to avoid the

[1] All but 20 of the 8,020 shares of the dividend stock were sold. Petitioner and his wife together owned 83.8% of the stock outstanding. Principal case at 464.

imposition of a penalty surtax thereon.[2] In reporting the sale of the preferred stock in their 1946 income tax returns, petitioner and other shareholders reported their proportion of the proceeds from the sale as a net long-term capital gain,[3] using a substituted basis as the cost basis of the preferred stock.[4] The Commissioner's determination that the issuance of the preferred stock constituted a dividend taxable as ordinary income was affirmed by the Tax Court.[5] On appeal, *held,* reversed. Despite tax-avoidance purpose and apparent prior negotiations for sale, a non-taxable stock dividend does not become a taxable cash dividend upon its sale by the recipient. *Chamberlin v. Commissioner,* (6th Cir. 1953) 207 F. (2d) 462.

Congress has provided generally for the inclusion in gross income of "dividends,"[6] and has defined that term in section 115(a) of the Internal Revenue Code.[7] However, Congress has qualified these provisions by excluding stock dividends to the extent that they do not constitute income within the Sixteenth Amendment.[8] In *Helvering v. Griffiths,*[9] the Supreme Court ruled that the statutory exclusion of stock dividends was not intended to cause re-examination of the rule in *Eisner v. Macomber,*[10] and held that a pro-rata distribution of stock does not constitute a taxable dividend unless it results in a change in the proportionate interests of the shareholders in the assets of the corporation.[11] The subsequent companion decisions in *Helvering v. Sprouse* and *Strassburger v. Commissioner*[12] indicated that the mere receipt of different shares of stock would

[2] I.R.C., §102. To the extent that corporate earnings are simply accumulated, the shareholder is insulated from initial receipt of income. Such accumulations, however, must be reasonable and clothed with business purpose, or be subjected to §102 penalty surtax at rates up to 38½%. Since §102 was not in issue in the principal case the decision therein is not precedent for avoidance of the penalty surtax.

[3] I.R.C., §§117(c), 117(h)(1) and (5).

[4] I.R.C., §113(a)(19).

[5] C. P. Chamberlin, 18 T.C. 164 (1952).

[6] I.R.C., §22(a).

[7] I.R.C., §115(a).

[8] I.R.C., §115(f)(1). The history of the stock dividend problem is a checkered one. The Revenue Act of 1913 contained no provision dealing with stock dividends. Under that act, the Supreme Court held, in Towne v. Eisner, 245 U.S. 418, 38 S.Ct. 158 (1918), that a dividend of common on common was not intended to be taxed. In Eisner v. Macomber, 252 U.S. 189, 40 S.Ct. 189 (1920), the Court further held that the Constitution barred imposition of a tax on a dividend of common on common. Thereafter, and until 1936, the revenue acts specifically exempted stock dividends. However, in Koshland v. Helvering, 298 U.S. 441, 56 S.Ct. 767 (1936), the Court held that a dividend of common on preferred did constitute income within the meaning of the Sixteenth Amendment, and in Helvering v. Gowran, 302 U.S. 238, 58 S.Ct. 154 (1937), the same holding was applied to a dividend of preferred on common where both preferred and common were outstanding. Sec. 115(f)(1) of the Revenue Act of 1936, 49 Stat. L. 1688, now §115(f)(1) of the Code, exempts stock dividends from tax only to the extent that they do not constitute income under the Constitution.

[9] 318 U.S. 371, 63 S.Ct. 636 (1943).

[10] 252 U.S. 189, 40 S.Ct. 189 (1920).

[11] Koshland v. Helvering, note 8 supra; Helvering v. Gowran, note 8 supra; Helvering v. Pfeiffer, 302 U.S. 247, 58 S.Ct. 159 (1937).

[12] 318 U.S. 604, 63 S.Ct. 791 (1943).

not in every case effect such a change in interest. The latter case held non-taxable a preferred dividend on common where, as in the principal case, only common was outstanding. In the absence of other circumstances, it would seem that the distribution of the preferred stock dividend in the principal case would be non-taxable, the *Strassburger* case controlling.[13] It is the additional "bail-out" feature which raises the question whether an otherwise non-taxable dividend becomes taxable because of immediate sale of the stock pursuant to prior negotiations fixing the terms of distribution and sale, and providing for mandatory redemption.[14] It is apparent that by use of the preferred stock "bail-out," shareholders in closely held companies are able to realize upon corporate earnings or to anticipate future dividends at long-term capital gain rates without substantial or permanent impairment of their ownership and control of the corporations. Although tax-avoidance purposes would not of themselves establish liability,[15] the Supreme Court has held[16] in the closely related field of tax-exempt reorganizations that legislative tax immunity[17] would be withheld unless a plan of reorganization has a legitimate purpose independent of tax saving motives. If in these reorganization cases the only change that is required to achieve successful avoidance is a shift from debentures to preferred stock which is to be immediately sold and redeemed, the business purpose and net effect doctrines declared therein would be rendered largely ineffective.[18] It is possible, however, to develop a policy aimed directly at the elimination of all tax-avoidance potentialities which would call for an overruling of the *Sprouse-Strassburger* decisions and require taxation of all dividend stock which is different from the stock on which it is declared.[19] Less speculative would be the adoption of a policy consistent with the decisions on non-taxable stock dividends by which the "bail-out" transactions could be distinguished and rendered taxable as ordinary income to

[13] There are those, however, who advance the argument for taxing all stock dividends regardless of the type of stock in which paid. See Lowndes, "The Taxation of Stock Dividends and Stock Rights," 96 UNIV. PA. L. REV. 147 (1947).

[14] See Darrell, "Recent Developments in Nontaxable Reorganizations and Stock Dividends," 61 HARV. L. REV. 958 (1948); DeWind, "Preferred Stock 'Bail-Outs' and the Income Tax," 62 HARV. L. REV. 1126 (1949).

[15] Gregory v. Helvering, 293 U.S. 465, 55 S.Ct. 266 (1935); United States v. Cummins Distilleries Corp., (6th Cir. 1948) 166 F. (2d) 17; Chisholm v. Commissioner, (2d Cir. 1935) 79 F. (2d) 14, cert. den. 296 U.S. 641, 56 S.Ct. 174 (1935).

[16] Gregory v. Helvering, note 15 supra; Bazley v. Commissioner, 331 U.S. 737, 67 S.Ct. 1489 (1947), together with the companion case, Adams v. Commissioner.

[17] I.R.C., §§112(b)(3), 112(g).

[18] Gregory v. Helvering, note 15 supra, declared the necessity for business purpose. In the Bazley and Adams cases, note 16 supra, the Supreme Court held that tax immunity would be denied a literal recapitalization, the net effect of which is a distribution that is essentially equivalent to the distribution of a taxable dividend.

[19] Those supporting this view reason that the receipt of the new preferred stock, without more, is a sufficient realization of income to justify the imposition of tax at the time of issue. See the concurring opinion of Opper, J., in the Tax Court's decision in the principal case, 18 T.C. 164 at 179 (1952). See also Frank J. and Herbert Kelly Trust, 38 B.T.A. 1014 (1938); DeWind, "Preferred Stock 'Bail-Outs' and the Income Tax," 62 HARV. L. REV. 1126 (1949).

the shareholder. It could plausibly be argued that the issuance and sale of the preferred stock are in effect a direct sale by the issuing corporation to the purchaser, for which the shareholder is a mere conduit,[20] the payment to the shareholder constituting a simple cash dividend.[21] Or the facts in certain cases might justify a finding that the shareholders in substance retain their entire stock interest and in effect merely assign or discount the right to receive future income.[22] Another contention would involve invoking section 115(g)[23] to treat the transaction as a taxable dividend at the time of redemption, but this would seem appropriate only where redemption is mandatory very shortly after sale.[24] In every case the incidence of taxation should depend on the substance of the transaction viewed as a whole.[25] The policies giving rise to the adoption of the business purpose doctrine in the reorganization cases should be equally applicable here in determining whether the stock dividend was in fact what it purported to be. Although the doctrine has had no application in cases of *liquidating* distributions,[26] the "bail-out" and reorganization transactions are more directly related in that they afford to shareholders a possible means of tax avoidance on corporate distributions of earnings which does not disrupt the shareholder's continuity of interest. In the principal case, the fact of sale pursuant to prior negotiations should have afforded a sufficient basis for distinguishing the stock dividend cases.[27] Furthermore, the provision for mandatory redemption which ultimately permitted the distribution of corporate earnings cannot be justified on the ground that it is of the kind usually required by sound investment

[20] "The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title." Commissioner v. Court Holding Co., 324 U.S. 331 at 334, 65 S.Ct. 707 (1945). See Wichita Terminal Elevator Co. v. Commissioner, (10th Cir. 1947) 162 F. (2d) 513.

[21] Congress has imposed no tax on liquidating distributions in kind or in dissolution. Treas. Reg. 118, §39.22(a)-20. Consequently, a corporation may liquidate or dissolve without subjecting itself to the corporate-gains tax, even though a primary motive is to avoid the burden of corporate taxation. United States v. Cumberland Public Service Co., 338 U.S. 451, 70 S.Ct. 280 (1950); General Utilities Co. v. Helvering, 296 U.S. 200, 56 S.Ct. 185 (1935). Although no business purpose was found in either of these cases, there is consistency in the decisions to the extent that, unlike the transaction in Commissioner v. Court Holding Co., note 20 supra, the Court found the transactions to be in fact what they purported to be.

[22] Commissioner v. Sunnen, 333 U.S. 591, 68 S.Ct. 715 (1948); Hort v. Commissioner, 313 U.S. 28, 61 S.Ct. 757 (1941); Helvering v. Horst, 311 U.S. 112, 61 S.Ct. 144 (1940).

[23] I.R.C., §115(g).

[24] If redemption were directly from the hands of the original recipient in a similar case, §115(g) of the Code would render it the equivalent of a taxable dividend. See Kirschenbaum v. Commissioner, (2d Cir. 1946) 155 F. (2d) 23.

[25] Commissioner v. Court Holding Co., note 20 supra.

[26] Note 21 supra. But see Commissioner v. Transport Trading and Terminal Corp., (2d Cir. 1949) 176 F. (2d) 570, cert. den. 338 U.S. 955, 70 S.Ct. 493 (1950).

[27] See the specific statements made by the Court in the Griffiths case, note 9 supra, at 372, and in the Strassburger case, note 12 supra, at 607, to the effect that the dividend stock had not been sold or redeemed.

policies, for whether or not stock dividends as such will be rendered marketable is a matter entirely unrelated to the business considerations of the corporate enterprise. If the corporate purpose is to raise additional capital for use in the business, rather than to distribute surplus, the stock could be sold directly to the public. If the decision of the principal case is allowed to stand,[28] the probable result will be to set a pattern whereby corporations can distribute earnings to shareholders at capital gain rather than dividend rates. This would be to permit the true nature of the "bail-out" transaction to be disguised by mere formalism, thereby frustrating effective administration of policies declared in related tax areas.

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[28] The proposed revision of the Internal Revenue Code, H.R. 8300, passed by the House March 18, 1954, would discourage preferred stock "bail-out" transactions. Sec. 309 of the bill would impose an 85% transfer tax on the corporation if the preferred stock is redeemed within ten years of the time it is issued, unless (1) the redemption is made in liquidation, (2) at the time of redemption there is a proportionate redemption of the stock on which the preferred is issued, (3) the redemption is of preferred stock issued for a contribution of property, (4) the redemption is treated as a dividend, or (5) the redemption is made to pay death taxes.