Wright v. Wrong: The Final Solution to the Dividend Equivalency Problem

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WRIGHT V. WRONG: THE FINAL SOLUTION TO THE DIVIDEND EQUIVALENCY PROBLEM

Marc Hankin*
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I. Introduction .................................... 1
II. Dividend Equivalency ............................................ 4
   A. Legislative History and Judicial Development ........................ 4
      1. Legislative History ........................................ 6
      2. Judicial Development of “Dividend Equivalency” .............. 11
   B. Analysis of the Tests for “Dividend Equivalency” .......... 19
      1. Typology of Tests ........................................ 19
         a. Section 304 Analysis .................................. 19
         b. The Automatic Dividend Rule ......................... 20
         c. The District Court’s Test in Shimberg ................. 20
         d. Partial Liquidation Analysis .......................... 21
         e. Revenue Ruling 75-83 .................................. 22
         f. The Wright Test ..................................... 23
         a. The Automatic Dividend Rule ......................... 24
         b. The District Court’s Test in Shimberg ................. 25
         c. Partial Liquidation Analysis .......................... 26
         d. Revenue Ruling 75-83 .................................. 26
         e. The Wright Test As a Solution ....................... 34
   III. Ratable Share of the Undistributed Earnings and Profits of the Corporation Accumulated After February 28, 1913 ............. 41
   A. Earnings and Profits Accumulated After February 28, 1913 ...... 41
   B. Which Corporation is “The Corporation?” ....................... 42
      1. The “Transferor Analysis” and the “Total Corporate Pool Approach” ........................................ 43
      2. Judicial Advances in the Search for the Source of E&P ........ 46
      3. The “Prior Ownership Approach” as a Solution .............. 49
   IV. Conclusion ................................................. 52

I. INTRODUCTION

When two or more corporations combine, the transaction

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may qualify as a reorganization under section 368(a) of the Internal Revenue Code. If it does, the corporations will not have to recognize any gain. In the course of the reorganization, the corporations may distribute property to their shareholders. The shareholders, in turn, need not recognize any gain if they receive stock, and in some cases other securities, of either of the reorganizing corporations in exchange for stock or securities issued by those corporations. But if the shareholders receive securities having too high a principal amount, or cash or other property, collectively referred to as "boot," they must recognize gain. The gain recognized may be treated as capital gain under section 356(a)(1) of the Code.

If the exchange has "the effect of a dividend" under section 356(a)(2), some or all of the gain recognized may be taxed at dividend rates. The proportion of the gain that is actually taxable as a dividend depends on the amount of earnings and profits available for the dividend treatment. This article addresses the issue of whether an exchange of stock for boot has the "effect of a dividend" within the meaning of section 356(a)(2).

The effect of section 356(a)(2) on the taxability of a distribution may be illustrated by the following hypothetical reorganization: A and B want to sell X their small vegetable wholesaling business with accumulated earning and profits of

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4. The use of the term "boot" appears to arise from the observation that, at the termination of a reorganization transaction, the shareholders making the exchange held stock in the new corporation "plus money to boot." Liddon v. Commissioner, 22 T.C. 1220, 1224 (1954); 64 Cong. Rec. 2852 (1923) (remarks of Rep. Green).
6. I.R.C. § 356(a)(2) (1976) provides:
   If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.
7. The term "dividend equivalency" is often used to characterize exchanges that have "the effect of a dividend" within the meaning of § 356(a)(2).
$25. Y Corporation, a supermarket chain whose net worth is 100 times that of X, is willing to either exchange one share of its publicly traded stock or pay $1.00 for each share of X in a statutory merger. A owns 80 of X's 100 outstanding shares of stock, B owns 20, and they both purchased their stock for $0.10 a share. B wants to receive only Y stock, but A prefers $40 and only 40 shares of Y stock. Under section 356(a)(1), A will be required to recognize as gain the portion of his boot which is less than or equal to the total gain he realized on his overall exchange in the reorganization.8

If A's exchange of $40 worth of stock for $40 worth of boot is found to have "the effect of a dividend" under section 356(a)(2), some boot will be treated as a dividend. Such treatment will only be imposed on the amount of boot that is not greater than the lesser of: (a) A's gain recognized on the overall exchange of his X stock, or (b) his ratable share of X's accumulated earnings and profits.9 Since the exchange of stock is assumed to have had the "effect of a dividend" under section 356(a)(2), A must report $20 of the $40 boot as dividends. The remaining $20 must still be recognized as capital gain under section 356(a)(1).10

Section 356(a)(2) itself does not indicate whether A's exchange has the "effect of a dividend." Courts, the Internal Revenue Service11 and commentators have been unable to set-

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8. A realized $72 gain in the reorganization, computed as follows:

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Fair market value (&quot;FMV&quot;) of Y stock</td>
<td>$40</td>
</tr>
<tr>
<td>FMV of boot</td>
<td>$40</td>
</tr>
<tr>
<td>Amount Realized</td>
<td>$80</td>
</tr>
<tr>
<td>Basis (80 shares in X times $0.10)</td>
<td>$8</td>
</tr>
<tr>
<td>Gain Realized</td>
<td>$72</td>
</tr>
</tbody>
</table>

Since the $72 gain realized is greater than the $40 boot, A must recognize the entire $40 boot as gain from the sale or exchange of property.

(a) A's gain recognized is $40. See infra note 15.
(b) A's ratable share of X's accumulated earnings and profits ("E&P") is $20.

80% ($25 accumulated E&P) = $20.

9. Hereinafter referred to as E&P. For a more detailed discussion of how B's ratable share of earnings should be computed, see infra Part III, footnotes 125-59 and accompanying text. For an explanation of the reasons for not including X's current earnings and profits, see infra Part III, section B, footnotes 127-59 and accompanying text.

10. (a) A's gain recognized is $40. See infra note 17. (b) A's ratable share of X's accumulated E&P is $20. 80% of $25 accumulated E&P = $20.

11. Hereinafter cited as the Service.
tle on one approach in determining the "true effect" of an exchange of stock for boot. As a result of this confusion, shareholders such as A must plan their transactions in accordance with the various tests that have been considered by the courts and commentators.

A survey of both the legislative history and judicial development of dividend equivalency under section 356(a)(2) shows that courts and commentators have recommended a variety of tests for the determination of dividend equivalency. An in depth analysis of these tests reveals that the only adequate test to determine whether an exchange has the "effect of a dividend" is the test adopted by the Eighth Circuit in *Wright v. United States*.\(^{12}\) All the other approaches generate results that are patently at odds with the purposes of the Code. This article further considers the different positions taken by courts with regard to the question of which corporation's E&P are available to characterize the shareholder's gain as a dividend, and whether only accumulated E&P are to be considered. The suggested method to determine the source of the dividend, and the amount of E&P properly allocable to the shareholder's boot set out and analyzed will show that the approach to dividend equivalency recommended herein should be employed by the courts.

II. DIVIDEND EQUIVALENCY

A. Legislative History and Judicial Development

Under the general rule of section 1001, a shareholder who sells stock or securities in one corporation in exchange for those of another corporation must recognize any gain or loss realized.\(^{13}\) This rule is suspended when the exchange is part of

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a reorganization as defined in section 368(a). If the shareholder receives boot, however, he must recognize the gain he realized, limited to the fair market value of the boot received.

When Congress first permitted the distribution of boot in an otherwise tax-free reorganization, section 203(d), the original predecessor of section 356(a), treated the transaction as gain from the sale of a capital asset. A loophole existed, however. Because the rate of tax on dividends was significantly higher than on capital gains, corporations could reorganize for the sole purpose of distributing boot to their shareholders. They could also withhold dividends for distribution in the course of an anticipated reorganization. They were thus able to "bail out" earnings at capital gains rates even though the distributions of earnings were more properly taxable to the shareholders as dividends. Congress therefore enacted section 203(d)(2), the predecessor of section 356(a)(2). The section provided that if an exchange of stock or securities for boot had "the effect of a dividend," the recognized gain was to be treated as a dividend to the extent of the shareholder's "ratable share" of accumulated E&P. No substantial

   (1) In General—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan or reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.
15. Section 356(a)(1) provides in pertinent part:
   (1) Recognition of Gain—If—
      (A) section 354 . . . would apply to an exchange but for the fact that
      (B) the property received in the exchange consists not only of property permitted by section 354 . . . to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.
16. Internal Revenue Act of 1924 (as amended), § 203(d), 42 Stat. 1560.
17. Internal Revenue Act of 1924, § 203(d)(2), 43 Stat. 253, 257. The statute provided in full:
   If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.
changes in the provision have since been made. 18

1. Legislative History

When Congress enacted section 203(d)(2), 19 it provided few indications of the section’s scope. 20 It is therefore unclear which exchanges of stock for boot Congress wished to characterize as having the “effect of a dividend.” The 1924 House and Senate Committee Reports 21 furnish only one example, “the 1924 Hypothetical,” of the abuse sought to be corrected by section 203(d)(2). A corporation merged into an empty shell for the sole purpose of bailing out, at capital gain rates, accumulated earnings and profits which were properly taxable as dividends. The predecessor corporation transferred to the shell all its assets including its accumulated earnings and profits. The shareholders of the predecessor corporation simultaneously exchanged their stock in the predecessor for the shell’s stock plus the earnings. According to the Committee Reports, section 203(d)(2) would prevent taxpayers from evading the taxes on dividends by withdrawing earnings at capital gain rates, under section 202(d), 22 through reorganizations.

Since the merger depicted in the 1924 Hypothetical was a blatant abuse of the reorganization provisions, 23 Congressional Paragraph (1) referred to the predecessor of § 356(a)(1), § 203(d)(1) of the Internal Revenue Act of 1924, which stated:

If an exchange would be within the provisions of paragraph (1), (2), or (4) of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

18. See supra note 6.
19. See supra notes 16-17 and accompanying text.
22. See supra note 16 and accompanying text.
23. The underlying presupposition of a reorganization is that it is to be undertaken for reasons germane to the conduct of the business venture. An adjustment in corporate form effected for the sole purpose of avoiding taxes is not one of the transactions contemplated as a corporate “reorganization” within the meaning of § 368(a).
intent may have been to limit dividend equivalence to reorganizations which are effected solely to bail out E&P. If this were true, a distribution of boot to a minority shareholder, who could not ordinarily compel such a distribution because of his lack of control, during a reorganization in which he receives only stock could not possibly have the "effect of a dividend." 24

The Treasury Regulations, the Service and the courts have correctly viewed section 356(a)(2) otherwise. 25 They have recognized that the non-recognition feature of a reorganization is founded on the assumption "that the new property is substantially a continuation of the old investment unliquidated." 26 The tax free exchange of stock and securities that accompanies the distribution of boot is thus viewed as affecting a mere adjustment in the form of a continuing investment, rather than a sale. Hence, the boot may properly be regarded as simply a distribution of property to a shareholder in his capacity as such, resulting in dividend rather than capital gain treatment. The term "effect of a dividend," however, gives little guidance in determining whether the view of the reorganization as a sale should apply to A’s boot, or whether the "substantially continued old investment" rationale should govern. The two approaches generate opposite results.

It has been argued that the 1924 Hypotheticalmakes it clear that an exchange which would have been treated as a dividend before the reorganization should never be granted capital gain treatment when made part of the reorganization. 28 The conclusion does not follow from the 1924 Hypothetical. The reorganization depicted was a clear attempt to abuse section 203(d), the predecessor of section 356(a)(1), by merging into a shell. It involved no reshuffling or mingling of interests such as occurs in an acquisitive reorganization. 29 If

24. See supra note 8 and accompanying text.
25. See, e.g., Treas. Reg. § 1.1001-1(c) (1972); Rev. Rul. 83, 1975-1 C.B. 112; Shimberg v. United States, 415 F. Supp. 832 (M.D. Fla. 1976), rev’d, 577 F.2d 283 (5th Cir. 1979). As the Eighth Circuit stated in Wright v. United States, 482 F.2d 600 (8th Cir. 1972), aff’d 29 A.F.T.R. 2d 72-1466 (E.D. Ark. 1972), “[A boot] distribution has some but not all the characteristics of either a sale or a dividend.” Id. at 604.
27. See supra notes 21-22 and accompanying text.
29. Today, the transaction would probably be classified as a type F reorganiza-
Congress intended dividend equivalency to be inferred whenever the exchange would have been a dividend had it preceded the reorganization, Congress would not have prescribed that the dividend within gain limitation should apply to the mere change in name effected in the 1924 Hypothetical. Pure dividend treatment could just as easily have been imposed.

This hypothetical redemption involves a pre-reorganization analytical approach. It would have been far more complicated to formulate a generally applicable method for applying a post-reorganization, constructive redemption analysis. The legislators could not simplistically direct that an exchange be treated as a dividend if it "would have had the effect of a dividend if it had followed the reorganization." If the redeeming shareholder held securities or more than one class of stock in the acquiring corporation after the reorganization, it would be unclear whether the hypothetically owned and redeemed instruments were securities, or stock that was common or preferred, voting or non-voting. Yet the character of the exchange of stock for boot would depend on the nature of the instrument redeemed.

The character of an exchange of stock for boot can be altered in a variety of ways by the complex changes that take place in a reorganization. The principles now embodied in section 302 had not yet been developed. Even if the drafters of...
section 203(d)(2) had been able to determine what types of

This paragraph shall not apply unless immediately after the redemption the shareholder owns less than 50 percent of the total combined voting power of all classes of stock entitled to vote.

(C) Definitions

For purposes of this paragraph, the distribution is substantially disproportionate if—

(i) the ratio which the voting stock of the corporation owned by the shareholder immediately after the redemption bears to all of the voting stock of the corporation at such time, is less than 80 percent of—

(ii) the ratio which the voting stock of the corporation owned by the shareholder immediately before the redemption bears to all of the voting stock of the corporation at such time.

For purposes of this paragraph, no distribution shall be treated as substantially disproportionate unless the shareholder's ownership of the common stock of the corporation (whether voting or nonvoting) after and before the redemption also meets the 80 percent requirement of the preceding sentence. For purposes of the preceding sentence, if there is more than one class of common stock, the determinations shall be made by reference to fair market value.

(D) Series of redemptions

This paragraph shall not apply to any redemption made pursuant to a plan the purpose or effect of which is a series of redemptions resulting in a distribution which (in the aggregate) is not substantially disproportionate with respect to the shareholder.

(3) Termination of shareholder's interest

Subsection (a) shall apply if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder.

(4) Application of paragraphs

In determining whether a redemption meets the requirements of paragraph (1), the fact that such redemption fails to meet the requirements of paragraph (2), (3), or (4) shall not be taken into account. If a redemption meets the requirements of paragraph (3) and also the requirements of paragraph (1), (2), or (4), then so much of subsection (c)(2) as would (but for this sentence) apply in respect of the acquisition of an interest in the corporation within the 10-year period beginning on the date of the distribution shall not apply.

(c) Constructive ownership of stock

(1) In general

Except as provided in paragraph (2) of this subsection, section 318(a) shall apply in determining the ownership of stock for purposes of this section.

(2) For determining termination of interest

(A) In the case of a distribution described in subsection (b)(3), section 318(a)(1) shall not apply if—

(i) immediately after the distribution the distributee has no interest in the corporation (including an interest as officer, director, or employee), other than an interest as a creditor,

(ii) the distributee does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years from the date of such distribution, and

(iii) the distributee, at such time and in such manner as the Sec-
instruments should be deemed hypothetically owned and re-
deemed, the legislators were not equipped with the tools to
characterize the redemptions.

Several attempts to amend section 356(a)(2) by adopting
the pre-reorganization, hypothetical redemption test have
been made, but Congress has rejected them all.32 Little can be
deduced, however, from these rejections, since the proposed
amendments also removed the dividend within gain limita-

retary by regulations prescribes, files an agreement to notify the Secre-
tary of any acquisition described in clause (ii) and to retain such records
as may be necessary for the application of this paragraph.
If the distributee acquires such an interest in the corporation (other
than by bequest or inheritance) within 10 years from the date of the
distribution, then the periods of limitation provided in sections 6501
and 6502 on the making of an assessment and the collection by levy or a
proceeding in the court shall, with respect to any deficiency (including
interest and additions to the tax) resulting from such acquisition, in-
clude one year immediately following the date on which the distributee
(in accordance with regulations prescribed by the Secretary) notifies the
Secretary of such acquisition; and such assessment and collection may
be made notwithstanding any provision of law or rule of law which oth-
erwise would prevent such assessment and collection.

(B) Subparagraph (A) of this paragraph shall not apply if—

(i) any portion of the stock redeemed was acquired, directly or
indirectly, within the 10-year period ending on the date of the distribu-
tion by the distributee from a person the ownership of whose stock
would (at the time of distribution) be attributable to the distributee
under section 318(a), or

(ii) any person owns (at the time of the distribution) stock the
ownership of which is attributable to the distributee under section
318(a) and such person acquired any stock in the corporation, directly or
indirectly, from the distributee within the 10-year period ending on the
date of the distribution, unless such stock so acquired from the distribu-
tee is redeemed in the same transaction.
The preceding sentence shall not apply if the acquisition (or, in the case
of clause (ii), the disposition) by the distributee did not have as one of
its principal purposes the avoidance of Federal income tax.
(d) Redemptions treated as distributions of property

Except as otherwise provided in this subchapter, if a corporation
redeems its stock (within the meaning of section 317(b)), and if subsec-
tion (a) of this section does not apply, such redemption shall be treated
as a distribution of property to which section 301 applies.

32. The first attempt was made in 1954. The House proposal recommended
treating the distribution as though it had been made by the acquired corporation
prior to the reorganization. H.R. 8300, 83rd Cong., 2d Sess. § 306 (1954). The propos-
al was rejected by the Senate. S. Rep. No. 1622, 83rd Cong., 2d Sess. 51 (1954). A
similar attempt was made in 1959. H.R. 4459, 96 Cong., 1st Sess. § 21 (1959). This
attempt was also rejected. Other proposals for statutory amendments have been
made. See XVIII ABA TAX SECTION BULL., No. 4, at 42-45 (July, 1965); AMERICAN
LAW INSTITUTE, FEDERAL INCOME TAX PROJECT SUBCHAPTER C TENTATIVE DRAFT NO. 1
tion, and prescribed that only the earnings and profits of the acquired corporation were to be available for the shareholder's dividend exposure. The proposed amendments may have been rejected because of any one of these additional recommendations or for some other reason.33

2. *Judicial Development of "Dividend Equivalency"

Initially, the courts invariably found that every distribution of property in the course of a reorganization had the effect of a dividend under section 203(d)(2).34 This approach reached its height in *Commissioner v. Estate of Bedford.*35 A corporation recapitalized in order to pay what was, in effect, a dividend. The Supreme Court found the distribution to be out of earnings and profits and therefore presumptively a dividend. The Court stated further that it could not see why any different treatment should apply to an exchange made in the course of an acquisitive reorganization.36

Soon afterwards, courts began to question the validity of this automatic dividend rule. The First Circuit abandoned the *Bedford* approach when it noted in *Lewis v. Commissioner*37 that it might have found that an exchange did not have the effect of a dividend, if the taxpayer had presented an argument for capital gain treatment.38 In *Lewis*, the predecessor corporation liquidated two of its three lines of business. Since the purpose of the reorganization was to protect the proceeds from the claims of the creditors of the last line of business, it appears that the First Circuit would have welcomed a partial liquidation analysis.39 The court’s reluctance to explicitly

33. In his testimony before the House Ways and Means Committee, Norris Darrel indicated that the boot treatment proposals in H.R. 8300 may not have been dropped because of specific objections, but were, rather, lost in the shuffle because of Senate objections to other portions of Subchapter C in the House bill. *Hearings on Topics Pertaining to the General Revision of the Internal Revenue Code Before the House Comm. on Ways and Means, 85th Cong., 2d Sess.,* pt. 3, at 2602 (statement of Norris Darrel). See also Darrel, *Internal Revenue Code of 1954—A Striking Example of the Legislative Process in Action, 1955 U.S. CAL. TAX INST.* 1.

34. See, e.g., *Commissioner v. Owens,* 69 F.2d 597 (5th Cir. 1939); *Woodard v. Commissioner,* 30 B.T.A. 1216 (1934); *McCord v. Commissioner,* 31 B.T.A. 342 (1934). See also Golub, "Boot" in Reorganization—The Dividend Equivalency Test of 356(a)(2), 58 TAXES 904, 907 (1980).

35. 325 U.S. 283 (1945).

36. Id. at 292.

37. 176 F.2d 646 (1st Cir. 1949).

38. Id. at 650-51.

39. If the corporation had not reorganized but instead distributed the proceeds
adopt this analysis and thereby abrogate Bedford's automatic dividend rule may have been due to the Supreme Court's statement in Bedford that the partial liquidation provisions had no bearing on dividend equivalence under section 356(a)(2).40

After Lewis, the mere fact that stock was exchanged for boot in the course of a reorganization no longer made the exchange per se equivalent to a dividend. It might instead be appropriate to treat the boot as the proceeds from the sale or exchange of an interest in property. The facts of the case, however, did not permit the First Circuit to consider whether, in an acquisitive reorganization, the contemporaneous tax-free exchanges of stock for stock might have an impact on the character of the exchange of stock for boot.

The Court of Claims began to focus on the reduction in corporate ownership effected by the exchange of stock for boot in Idaho Power Co. v. United States41 and Ross v. United States.42 The court noted in both cases that an important indicium of dividend equivalency would be present if the shareholder had "substantially the same interest in the corporation after the payment as he had before."48

In Idaho Power, the court found that a shareholder's exchange of stock for boot did not have the effect of the distribution of a dividend. The holding relied on both the reduction in his voting power that was caused by the reorganization and the drop in the value of the shareholder's corporate investment.

In Ross, the Court of Claims continued this line of analysis by ruling that section 356(a)(2) was to be read in pari materia with section 302.44 While contradictory language in the Ross opinion casts some doubt on the court's intent, it is assumed that the court intended to adopt a redemption analy-

40. See infra note 76.
43. Id. at 798; Idaho Power, 161 F. Supp. at 810.
44. See infra notes 120-22 and accompanying text. Earlier decisions had also ruled that § 356(a)(2) was to be read in pari materia with § 302. Hawkinson v. Commissioner, 235 F.2d 747, 751 (2d Cir. 1956); Kirschenbaum v. Commissioner, 155 F.2d 23, 24 (2d Cir. 1946), cert. denied, 329 U.S. 726 (1946).
The court appeared to take the position that if an exchange would have been treated as a dividend if it had preceded the reorganization then its character should be the same when it is made in the course of a reorganization.

This analysis breaks down the reorganization into two transactions: the shareholder's "intra-corporate" boot exchange, to be analyzed under section 302 principles, followed by his "inter-corporate" tax-free exchanges. Since this approach ignored those changes in the contours of the "redeeming" shareholders' ownership that resulted from the reorganization, it was inconsistent with Idaho Power. Thus, the position of the Court of Claims on dividend equivalency became unclear.

The Tax Court's decision in McDonald v. Commissioner appeared to question the validity of bifurcating the reorganization into two separate exchanges in the manner approved by the Ross court. A redemption immediately preceding a reorganization was found not essentially equivalent to a dividend under section 302(b)(1). The Service admitted the existence of the reorganization, but claimed that the redemption was a separate transaction which did not satisfy any of the tests.

45. After having explicitly rejected the automatic dividend rule, and having held that § 356(a)(2) was to be read in pari materia with § 302, the Ross Court stated: "The question is whether a dividend by the [transferor] would have accomplished the same result as the distribution of the [boot] by the [transferee]." Ross, 173 F. Supp. at 798. Since the opinion appeared to be based on a determination of whether the shareholder's interest in the corporation was sufficiently reduced after the exchange, it is assumed that the court meant to say that the question was whether a redemption by the transferor, before the reorganization, would have accomplished the same result as the distribution of boot by the transferee. Accord Golub, supra note 34 at 908.

46. Several earlier cases approved the same line of analysis, seeming to reject the automatic dividend rule. But in each such case the exchange was found to have the effect of a dividend nevertheless. See, e.g., Hawkinson, 235 F.2d at 751; Kirschenbaum, 155 F.2d at 24.

47. 52 T.C. 82 (1969).

48. The tax court's acceptance of the applicability of § 302 to the exchange of stock for a distribution of property seems at odds with its analysis in American Mfg. v. Commissioner, 55 T.C. 204 (1970). There, the tax court held that an exchange of stock for boot in the course of a reorganization should be characterized under I.R.C. § 356 (1976) rather than I.R.C. § 301 (1976 & Supp. IV 1977-1981). Id. at 214-31. It appears that § 356(a)(2) was not raised in McDonald by the government or by the taxpayer.

49. The Service later changed its mind and claimed that a taxable sale, rather than a reorganization had taken place. Rev. Rul. 75-360, 1975-2 C.B. 110. The Service may have been implying that a redemption divesting the corporation of earnings and profits had not taken place.
under section 302(b) for sale or exchange treatment. In holding that a substantial change in ownership had taken place, the Tax Court noted that the redemption and the reorganization were merely steps in an integrated plan. Under the doctrine of Zenz v. Quinlivan, only the final results of the plan were significant for the determination of dividend equivalency.

As a result of the contrary interpretations by McDonald and Zenz courts, the Ross court's reading section 356(a)(2) in pari materia with section 302 became subject to the question. If section 302 was read to take into consideration those changes in the redeeming shareholder's ownership that result from the reorganization, then section 356(a)(2) must a fortiori do no less.

In 1973, a court for the first time interpreted section 356(a)(2) as requiring the application of section 302 tests to a post-reorganization, constructive redemption of the acquiring corporation's stock. The Eighth Circuit held in Wright v. United States that reading section 356(a)(2) and section 302 in pari materia mandate the use of the "net effect" standard explained in Zenz v. Quinlivan. Courts had long held that the extent of the reduction in the shareholder's economic ownership and voting power determined the character of his exchange of stock for boot. The most important and novel feature of the Wright decision was its ruling that the "net effect" standard required consideration of the reorganization's impact on the reductions to be measured. The Eighth Circuit believed that only a post-reorganization, constructive redemption analysis could properly factor in the impact of the reorganization. The court held that the taxpayer's exchange of stock for a note resulted in a "meaningful change" in his proportionate interest in the corporation. The distribution of the note was "not essentially equivalent to a dividend" under section 302(b)(1) and did not have "the effect of a dividend" under section 356(a)(2).

50. 213 F.2d 914 (6th Cir. 1954).
52. 213 F.2d 914 (6th Cir. 1954) (holding that the net effect of a redemption followed by a sale, where both exchanges were part of one integrated transaction, was a sufficient reduction in ownership to qualify the redemption for capital gain treatment).
53. Wright, 482 F.2d at 610.
The taxpayer in *Wright* owned 99.2% of one corporation and 56% of another before their consolidation into a new corporation in which he had a 61.7% interest. In order to create the desired proportions of ownership, the taxpayer received a distribution of boot and the other major shareholder gave the consolidated corporation a promissory note in exchange for some of his stock. The taxpayer lost the complete control he formerly had and suffered a 23.3% reduction in his right to dividends and assets on liquidation.\(^{54}\)

The Eighth Circuit justified its application of the section 302 tests to the consolidated corporation by noting that it would be artificial to view the boot as coming separately from one of the preconsolidated corporations. They had been dissolved as part of the plan of reorganization and a redemption analysis makes sense only in relation to a corporation that will continue to exist. The court mentioned in a footnote that the distribution was not a pro rata one since the taxpayer received his distribution in his capacity as a shareholder in the consolidated corporation.\(^{55}\)

The *Wright* court also held that the boot should be regarded as having come from the consolidated enterprise, rather than from one of its corporate components, since the reorganization was based on the corporations' combined capital accounts. It would therefore have been immaterial if one of the pre-merger corporate components, rather than the consolidated corporation, had issued the note. The court logically found that the boot was distributed in exchange for a stock interest in the consolidated corporation that the taxpayer would have received if the reorganization had been free of boot.\(^{56}\)

It is noteworthy that the *Wright* court might have found that the distribution had the effect of a dividend if the Service had only argued that the constructive ownership rules of section 318\(^{57}\) applied. The dissent objected that they should logically apply to section 356(a)(2) since the court was con-

\(^{54}\) *Id.*

\(^{55}\) *Id.* at 608 n.16.

\(^{56}\) *Id.* at 607.

\(^{57}\) I.R.C. § 318 (1976) makes related persons the constructive owners of each other's stock. This prevents related persons who control a corporation from bailing out earnings at capital gains rates through redemptions which effect no meaningful change in their respective ownership.
struing it *in pari materia* with section 302. But the majority refused to consider section 318 since the Service had failed to claim its applicability.

The Service was quick to reject the *Wright* decision for its refusal to treat the distribution of boot as though it has been made by the acquired or transferor corporation. In Revenue Ruling 75-83, the Service reaffirmed its recent retreat from *Bedford*'s automatic dividend rule, but aligned itself against the Eighth Circuit with those courts that had determined dividend equivalency under section 302 principles. The example used in the 1924 Hypothetical was cited as mandating a bifurcated analysis which accorded distributions the same character they would have had if they had been made before the reorganization, but without any relation to it.

In 1978, the Fifth Circuit agreed with the service in *Shimberg, Jr. v. United States* that the character of an exchange should not be altered because it is part of a reorganization. The district court had held that an exchange of stock for boot did not have the effect of a dividend. The analysis which the appellate court offered to justify its reversal of the district court's holding, that an exchange of stock for boot did not have the effect of a dividend, appeared to be a return to

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58. *Wright*, 482 F.2d at 610-13 (Bright, J., dissenting). See supra note 57.

59. The Eighth Circuit had recently held that the Service's failure to raise theories, code sections, or regulations on which it relied before or at trial denied the taxpayer fair notice and an adequate opportunity to defend against presumptively correct deficiency assessments. The court's unwillingness to ignore that decision should not be taken as a rejection of the applicability of § 318 to § 356(a)(2).


62. The Service's conclusion that a bifurcated analysis followed from the example of the 1924 Hypothetical was not explained and the contrary implications of the *Zenz* and *McDonald* decisions were not considered. See supra notes 19-22, 47-49 and accompanying text.

A few months earlier, however, the Service had issued another ruling that effectively re-opened the door for a return to the automatic dividend rule. In Revenue Ruling 74-516, the Service "explained" that the principles developed under section 302 may only "in appropriate cases" serve as useful guidelines in applying 356(a)(2) to a distribution. Under the vague drafting of the ruling, the Service had the unbridled freedom to decide whether a taxpayer's distribution was an "appropriate case." Rev. Rul. 515, 1974-2 C.B. 121; see also Rev. Rul. 515, 1974-2 C.B. 118.

63. 577 F.2d 283 (5th Cir. 1978), cert. denied, 439 U.S. 1115 (1979).

64. *Id.* at 289. The 1924 Hypothetical ostensibly made it clear that this was Congress' intent. In a baseless comparison, the Fifth Circuit concluded that the facts in *Shimberg* were virtually identical to those of the 1924 Hypothetical. *Id.* at 289 n.16.
the automatic dividend rule. The court pointed out that it was dealing with a distribution that it considered pro rata, and denied that it was embracing the discredited \textit{Bedford} rule. The court's \textit{ratio decidendi} seemed to indicate otherwise. Its precedential value is therefore subject to question.

In \textit{Shimberg}, a construction company in which the taxpayer and his wife owned a 68.4\% interest merged into an unrelated, diversified holding corporation. Under an arrangement analogous to A's and B's transfer of their vegetable wholesaling business to the Y conglomerate, the shareholders of the acquired corporation received boot and a pro rata share of stock in the acquiring corporation. The district court, in a misguided attempt to employ the \textit{Wright} test, erroneously compared the taxpayer's ownership in the construction company with his post-merger actual proportionate ownership in the holding company. Had it correctly applied the \textit{Wright} test, the court would have compared the taxpayer's pre-organization constructive ownership in the \textit{holding} company with his post-merger actual proportionate ownership in it. Having found a 23\% reduction, the district court concluded that the taxpayer's hypothetical redemption was not essentially equivalent to a dividend under section 356(a)(2), as viewed through the principles of section 302(b)(1).

The Fifth Circuit, apparently unaware that the district court incorrectly applied the \textit{Wright} court's test, overreacted. It noted that the taxpayer in \textit{Shimberg} never held an interest before the reorganization in the very corporation whose stock the district court considered hypothetically redeemed. The


66. \textit{See supra text accompanying note 8}.

67. This point was also raised in a recent article which supported, under certain circumstances, the position that the acquired corporation should be treated as the one making the distribution. Additional objections were that the shareholder may not have had the option of receiving the additional stock in the acquiring corporation, that the shareholders of the acquiring corporation may have insisted that boot be distributed, and that it would be mere guesswork to predict the kind and quality of stock that the shareholder would have received but for the distribution of boot. Samansky, \textit{supra} note 20 at 29, 49-50. The problem with the first two objections is that they could apply equally well to the approach which views the acquired corpora-
court perceived this as a significant feature distinguishing the case from *Wright* and supporting the conclusion that a redemption analysis was inapplicable to the *Shimberg* transaction. The Fifth Circuit did not express an opinion on whether *Wright* itself was correctly decided.

The *Shimberg* decision was notable because it rejected the applicability of any form of redemption analysis to the characterization of boot received in an acquisitive reorganization. The ruling was also the most recent one to refuse to read section 302 and section 356(a)(2) *in pari materia*. The acquired corporation in *Shimberg* had enough accumulated E&P to cover the distribution and it seemed that the exchange of stock for boot was therefore held to have the effect of a dividend.

Since the Fifth Circuit did not explicitly state the grounds for its rejection of the rule that section 356(a)(2) is to be read *in pari materia* with section 302, the rationale for the court's holding that neither a meaningful reduction in ownership nor a reduction in control are at issue cannot be analyzed. The case appears to lack any analytic basis other than a presumption that a distribution is out of E&P to the extent thereof. It can only be regarded as a retrogression to the discredited automatic dividend rule. The Fifth Circuit's holding is indicative of the confusion that exists with respect to the proper test for determination of "dividend equivalency."
B. Analysis of the Tests for "Dividend Equivalency"

1. Typology of Tests

The various approaches to dividend equivalency under section 356(a)(2) may most clearly be viewed in the context of a hypothetical reorganization such as the one posited above for A and B.

a. Section 304 Analysis

Some limited controversy has centered on the applicability of section 304 to stock for boot exchanges made in the course of the reorganization of corporations under common control. The terms of section 304 do not describe any of the exchanges listed in section 356(a)(2) without a strained reading of one or the other statute. Still, a hypothetical transac-

69. It should be noted at the outset that the Treasury has in its arsenal a vaguely drafted provision, Treas. Reg. § 1.301-1(1) (1979), which provides an additional framework for finding that boot is essentially equivalent to a dividend. When applied to an acquisitive reorganization, the regulation simply characterizes the boot distribution as a separate transaction which is independent from the reorganization and therefore governed by § 301. Section 356(a)(2) thus becomes irrelevant since it applies only to the property received as part of a plan of reorganization. The status is significant since § 356(a)(2) limits dividend treatment to the lesser of the gain realized or the shareholder's ratable share of earnings and profits. Section 301, on the other hand, has no such limitation. Treas. Reg. § 1.301-1 (1979) is a codification of a position taken by the Supreme Court in Bazely v. Commissioner, 331 U.S. 737 (1947), and Gregory v. Helvering, 293 U.S. 465 (1934), with respect to recapitalizations and to incorporations lacking in economic substance. While the danger exists that any distribution of boot could be regarded as separate and independent from the reorganization exchange, the regulation indicates that it will generally apply to recapitalizations, mergers into empty shell corporations, and to reincorporations. It should not present a significant threat in the case of an acquisitive reorganization unless the surviving corporation appears to be so lacking in assets that it was acquired solely for the use of its shell or its tax attributes. But see infra notes 141-45 and accompanying text.

70. See supra text accompanying note 8.

71. I.R.C. § 304 (1976) prevents a shareholder from bailing out dividends of commonly controlled corporations at capital gain rates by selling to one corporation stock that he owns in the other. The proceeds of the "sale" are treated as a dividend under § 304.


73. Section 304 cannot apply to a type A merger or consolidation because, among other things, the issuing corporation ceases to exist at the moment of the reorganization and the availability of its earnings and profits for the dividend thus becomes problematic. Section 304 cannot apply to a type B reorganization where the shareholder receives boot in exchange for his old stock because the exchange of his old stock for boot must be made with the corporation that issued it to him. For the
tion fitting within the terms of section 304 could theoretically be employed in order to use section 304's principles in determining dividend equivalency under section 356(a)(2). Neither the courts nor the commentators, however, have suggested a consistent way to fit the two sections together. Section 304 analysis has therefore never been applied to boot in the context of a reorganization.

b. The Automatic Dividend Rule

Under the "automatic dividend rule" established in Commissioner v. Estate of Bedford74 the distribution will always have the "effect of a dividend" so long as there are enough earnings and profits to cover the distribution. If the automatic dividend rule were applied to A's boot, he would have to report $20 of dividend income, as he did in the hypothetical reorganization shown above, and $20 of capital gain. If B were to exchange ten of his twenty shares for $10, he would have to recognize a $10 gain under section 356(a)(1). The exchange would have the "effect of a dividend" according to the automatic dividend rule and B would report $5 of his gain as a dividend under section 356(a)(2).

c. The District Court's Test in Shimberg

Another test for dividend equivalency was employed by the district court in Shimberg v. United States.75 The trial court posited a redemption of stock equal in value to the boot distributed to the shareholder. It inquired whether the redemption constituted a "meaningful reduction" in the shareholder's corporate ownership or was "substantially disproportionate" according to the principles developed under section 302. The court compared the percentage of the acquired corporation that the redeemed shareholder owned before the hypothetical redemption with the percentage of the reorganized entity that he owned after the hypothetical redemption. The disparity was held great enough to warrant capital gain treatment under section 302 and therefore under section 356(a)(2) as well.

A's proportionate ownership dropped from 80% of X to less than one percent of Y. Such a reduction in ownership would easily satisfy the principles of section 302(b)(1) or sec-

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74. 325 U.S. 283 (1945).
75. 415 F. Supp. 832 (M.D. Fla. 1976), rev'd, 577 F.2d 283 (5th Cir. 1979).
tion 302(b)(2) in the context of a single corporation. A’s exchange of stock for boot in the course of the reorganization would therefore not have the effect of a dividend under section 356(a)(2) according to the district court’s test. He would be entitled to capital gain treatment on the entire $40. If B exchanged one half of his stock for boot, his corporate ownership would drop from 20% to less than one percent whether or not A also “redeemed” one-half of his stock. B would also get pure capital gain treatment.

d. Partial Liquidation Analysis

A fourth possible approach would determine the dividend equivalence of certain distributions according to the principles developed under the partial liquidation provisions of section 346.76 Satisfaction of that section’s requirement would entitle the shareholder to pure capital gain treatment.

A partial liquidation analysis might be applied to B’s boot under the following circumstances: Assume that, instead of having only a vegetable wholesaling business, X had ten separate lines of business which it had operated for more than five years. Y wants to purchase only six lines of business, but X is unable to liquidate the other four profitably. As part of the plan of reorganization, Y promptly employs its superior marketing resources to sell them profitably. Y then distributes all the proceeds to A, or to both A and B pro rata, in a hypo-

76. I.R.C. § 346 (1976). Some commentators take the position that dividend equivalency could be tested under the principles of § 346. It has been argued that § 346 is relevant, but only if, as part of the reorganization plan, the acquiring corporation sells assets to a third party and distributes the proceeds in a manner which would, absent the reorganization, comply with the requirements of § 346. Samansky, supra note 20, at 14. It would be unreasonable if a distribution, which would have qualified as a partial liquidation before the reorganization, were characterized as a dividend merely because it was made as part of a reorganizing transaction. Several commentators contend that approval of this approach can be inferred from Lewis v. Commissioner, 176 F.2d 656 (1st Cir. 1949). See Golub, supra note 34, at 907; Moore, Taxation of Distributions Made in Connection with a Corporate Reorganization, 17 Tax L. Rev. 129, 145-47 (1961). The Service’s position on the applicability of § 346 is unclear. The Service argued in Commissioner v. Estate of Bedford, 324 U.S. 283 (1945), that the partial liquidation and dividend equivalency rules were completely dissimilar and that the existence of the partial liquidation in Bedford was therefore irrelevant. The Service’s position in Commissioner v. Snite, 177 F.2d 819 (7th Cir. 1949), a partial liquidation case, may have indicated a change of position since the Service drew support from Bedford in arguing for dividend equivalency. See B. Bittker & J. Eustice, supra note 29, § 14.34, at 14-119. See also Wittenstein, Boot Distributions under Section 112(c)(2): A Re-Examination, 8 Tax L. Rev. 63 (1952).

theoretical redemption of their stock. A section 302(b)(4) analysis would support capital gain treatment. The distribution would be attributable to X's ceasing to conduct a business; X, now submerged in Y, would be actively engaged in a business immediately after the distribution; and all of the businesses involved would have been owned and operated by X for more than five years preceding the distribution.\textsuperscript{78}

Decisions hinging on a section 302(b)(4) analysis have not come down. At least one opinion, however, suggested that a court might have entertained a partial liquidation analysis in testing for dividend equivalency under section 356(a)(2), if the taxpayer had raised the argument.\textsuperscript{79}

e. \textit{Revenue Ruling 75-83}

A fifth test, approved by the Service in Revenue Ruling 75-83, postulates a hypothetical redemption of the stock of the target corporation.\textsuperscript{80} The redemption occurs before the reorganization. If the stock redeemed would be equal in value to the boot received, and if the redemption would have qualified for sale or exchange treatment under section 302 had the reorganization not taken place, then the distribution of boot will not be deemed to have the effect of a dividend.\textsuperscript{81}

Returning to A's transaction, his exchange would have the "effect of a dividend." A redemption of 40 of his shares before the reorganization would have left him owning 66\% of X. Since his exchange would have been treated as a dividend under section 302(d) had it preceded the reorganization, it will have the same effect when made a part of that transaction. But A will have only $20 worth of dividend income and

\textsuperscript{78} Section 302(b)(4) provides that a distribution will be treated as received in partial liquidation, so long as the distribution is pursuant to a plan, occurs within the taxable year in which the plan is adopted or the succeeding taxable year, and the following requirements are met: "(1) [t]he distribution must be attributable to the corporation's ceasing to conduct, or must consist of the assets of, a trade or business; (2) [i]nmediately after the distribution, the distributing corporation must be actively engaged in a trade or business; (3) [b]oth the retained trade or business and the one which was distributed (or which gave rise to the distribution) must have been actively conducted (although not necessarily by the distributing corporation) throughout the five-year period preceding the distribution; and (4) [n]either trade nor business may have been acquired by the distributing corporation within the preceding five years in a transaction in which gain or loss was recognized in whole or in part." I.R.C. § 302(b)(4); B. Bittker & J. Eustice, \textit{supra} note 29, at § 9153.

\textsuperscript{79} Lewis v. Commissioner, 176 F.2d 646, 650-51 (1st Cir. 1949); \textit{see supra} notes 37-38.

\textsuperscript{80} Rev. Rul. 83, 1975-1 C.B. 112.

\textsuperscript{81} Id. at 113.
$40 worth of capital gain since the exchange is governed by section 356(a)(2).

If instead of A, B exchanged one-half of his stock for boot and a reorganization did not take place, the redemption would reduce his ownership of X from 20% to 11%. The $10 would qualify for sale or exchange treatment under section 302(b)(2) and would therefore not have the "effect of a dividend" under section 356(a)(2). The entire amount of the boot would be recognized as capital gain.

If A sells one-half of his stock to Y for cash at the same time as B, neither exchange will have the effect of a dividend. A pro rata redemption of one-half of both shareholders' stock before the reorganization would have been treated as a dividend under section 302(d), and will therefore have the same character under section 356(a)(2).

f. The Wright Test

The Eighth Circuit chose a different course in Wright v. United States.82 The court held that dividend equivalence should be determined by hypothesizing a post-reorganization redemption. The shareholders of the acquired corporation are deemed to have first made a boot-free exchange of stock and securities in the acquired corporation for stock and securities in the reorganized entity. An amount of stock in the reorganized corporation equal in value to the boot is deemed subsequently redeemed and tested under section 302 principles.83

A redemption of Y stock after a boot-free exchange by A results in a drop in ownership from approximately 0.8% to approximately 0.4%. This is a fifty percent reduction which qualifies under section 302(b)(2). Hence, the Wright court's approach would generate the result that the distribution of boot did not have the effect of a dividend to A. The entire $10 would be recognized as capital gain. Moreover, even if B had also received cash for one half of his X stock, both former shareholders' ownership in Y would have hypothetically dropped by almost 50%. Since the hypothetical redemption of their stock would not be a pro rata distribution to them in their capacity as Y shareholders, both distributions would qualify for capital gain treatment under section 302 and section 356(a)(2). An analysis of the various tests enumerated

82. 482 F.2d 600 (8th Cir. 1973) aff'g 29 A.F.T.R. 2d 72-1466 (E.D. Ark. 1972).
83. Id. at 607-08.
above will demonstrate that the Wright test is the only adequate approach and should be followed by the courts.84

2. Analysis of "Dividend Equivalency" Tests

a. The Automatic Dividend Rule

Bedford's interpretation of section 356(a)(2) rests on the assumption that Congress intended that dividend treatment should result only "[i]f an exchange . . . has the effect of the distribution of a dividend," since Congress was unable to devise a less convoluted way of saying that all distributions should have the effect of a dividend. This approach is generally thought to be without merit.85

The weaknesses of the automatic dividend rule extend beyond the need for a convoluted interpretation of the word "if." Treasury Regulation section 1.1002-1(c) sanctions the view of a reorganization as a "mere adjustment in the form of investment."86 This perspective raises the possibility of treating the boot purely as payment in redemption of stock, rather than partly as a distribution of property to A or B in their capacity as shareholders.87

Requiring B to treat as a dividend the transformation of one half of his X stock into cash is patently unfair. His three critical shareholder rights, as identified by Himmel v. Commissioner,88 have been drastically reduced. His right to exercise voting power has been cut by more than half. Moreover, his rights to dividends and to assets on liquidation have been reduced by one half. Had such a redemption occurred long

84. See supra notes 69-83 and accompanying text.
85. See Wright, 482 F.2d 600; Darrel, supra note 33; Fassler, supra note 12; Gerson, Boot Dividends and the Automatic Dividend Rule: Bedford Revisited, 11 WM. & MARY L. REV. 841 (1970); Moore, supra note 76; Shoulson, supra note 20; Wittenstein, supra note 76.
86. Treas. Reg. § 1.1002-1(c) (1980).
87. Thus, if the reorganization is viewed as adjusting the form, but not the nature of a shareholder's investment, the principles of § 302 should continue to be available to characterize the shareholder's exchange of his stock for a distribution of property. See supra note 25 and accompanying text.
88. 338 F.2d 815 (2d Cir. 1964). The court defined a shareholder's interest as including: (1) the right to vote and thereby exercise control; (2) the right to participate in current earnings and accumulated surplus; and (3) the right to share in net assets on liquidation. The court held that a redemption sufficiently reducing these rights may result in a "meaningful reduction" in a shareholder's proportionate interest in the corporation, and thereby qualify the redemption as "not essentially equivalent to a dividend" under I.R.C. § 302(b)(1) (1976). See Rev. Rul. 502, 1975-2 C.B. 111.
enough before the merger B would unquestionably have been entitled to sale or exchange treatment under section 302(b)(2).

b. *The District Court's Test in Shimberg*

While the automatic dividend approach may be faulted for ignoring the sale aspect of a reorganization in determining the character of a distribution, the test employed by the district court in *Shimberg* overemphasizes the sale approach. Whenever a small business is merged into a large conglomerate, the district court's test will generate the result that the taxpayer suffered a meaningful reduction in ownership. His proportionate ownership in the conglomerate will always be substantially less than the proportionate ownership he had in his business before. Applied to such reorganizations, the district court's redemption analysis will invariably give the shareholder's exchange of stock for boot a capital gain treatment. The role of the reorganization as a "readjustment of a continuing interest in property under modified corporate form" will be disregarded in such reorganizations since no exchange could possibly have the effect of a dividend. This approach also effectively eliminates the requirement that a redemption, whether hypothetical or actual, must effect a substantial reduction in the value of one's corporate investment in order to qualify for capital gain treatment. The surrender of an insignificant amount of stock for boot could otherwise result in capital gain. As the Fifth Circuit noted in reversing the district court's decision, section 356(a)(2) could thus be effectively read out of the Code. The district court's test has never been used again.

Thus, both *Bedford's* automatic dividend rule and the district court's approach in *Shimberg* tend each to overemphasize one aspect of a reorganization. This renders them both of little use in interpreting the terms of section 356, and underscores the need for an approach that deals effectively and consistently with the dual nature of a reorganization.

89. 415 F. Supp. 832 (M.D. Fla. 1976), rev'd, 577 F.2d 283 (5th Cir. 1979); see supra note 75 and accompanying text.
92. See B. BITTKER & J. EUSTICE, supra note 29, § 9.01.
c. Partial Liquidation Analysis

The applicability of a section 346 analysis to an exchange of stock for boot in a reorganization will always be uncertain and the Service can be relied on to argue for dividend equivalency. If the trades or businesses sold are not disposed of simultaneously with the reorganization or soon thereafter, the Service will probably claim that the sale was unrelated to the boot. The taxpayer will, moreover, bear the burden of showing that the boot consisted of proceeds from the "partial liquidation" rather than an unrelated distribution of earnings.

Even if he passes those and other hurdles, the shareholder arguing for partial liquidation treatment will probably face a hostile judicial climate. The courts have never applied a section 346 analysis to a section 356(a)(2) setting. Furthermore, dictum in Bedford indicated that the Supreme Court felt that the two provisions were entirely unrelated.

Corporations generally effect the partial liquidation before the reorganization rather than face the probability that a pro rata distribution of boot in a reorganization would be held to have the effect of a dividend. This technique is relatively safe and advisable. It should be noted that the Service could claim that the partial liquidation and the merger were all steps in one integrated transaction. This would bring the distributions back within the purview of section 356(a)(2) resulting in dividend treatment. But the Service has thus far respected the separateness of partial liquidations followed by reorganizations and it is unlikely that the Service will change its position.

d. Revenue Ruling 75-83

Revenue Ruling 75-83 recognizes the tension between the two aspects of a reorganization. An exchange of stock for boot can be purely capital in nature. This favorable treatment is conditioned on the shareholder's substantially reducing his overall corporate investment, regardless of which corporation pays the boot.

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94. See supra notes 37-40, 76-79 and accompanying text.
95. See B. Bittker & J. Eustice, supra note 29, ch. 9, pt. E.
98. The ruling stated: "[I]t is appropriate to look to principles developed under
The justification for this analysis is similar to that underlying section 302. The shareholder's hypothetical sale of only a small amount of debt or equity to the acquired or acquiring corporation will not terminate his continuing status as a shareholder. The exchange will have little or no influence on his standing in the new corporation regardless of which corporate entity pays. If there is no meaningful reduction in both (1) the value of his investment and (2) his proportionate control of the corporate structure, as a result of his exchange of stock for boot, that exchange will not result in a change in the "kind or extent" of his corporate investment. His boot, in such cases, cannot be properly viewed as the proceeds from the sale, back to the corporation, of an interest in property. It must presumptively be viewed instead as having the effect of a distribution of earnings and profits.

The hypothetical redemption approach adopted by the Service in Revenue Ruling 75-83 gives some effect to these legitimate concerns. In determining dividend equivalency, it focuses on the acquired corporation, typically referred to as the "target" corporation. The ruling appears to generally incorporate the technical requirements of section 302 in pari materia. A 20% reduction in the value of the shareholder's investment in the corporation is required for capital gain treatment by the safe harbor provision of section 302(b)(2)(C). The shareholder's proportionate ownership of the target's total outstanding equity must also drop by at least 20%, according to that section.

Section 302(b)(2)(B) further requires that ownership of the target be reduced to a point below 50% voting control. For example, if X were not undergoing a merger when it redeemed 45 of A's shares, A would suffer a more than 20%
drop in ownership but he would still control X. His retention
of the power to manipulate the corporation could preclude a
"meaningful change" in both the absolute and the proportion-
ate value of his interest in X. Unless X redeemed more than
60 of A's shares, the redemption would not qualify for capital
gain treatment under section 302(b)(2) and might fail section
302(b)(1) as well. The 50% requirement thus prevents a cor-
poration from using a mere shuffling of papers to distribute
earnings to its larger shareholders at capital gains rates.

Revenue Ruling 75-83 suffers from certain shortcomings
because it focuses the section 302 tests on the target corpo-
ration. Section 302 was designed to characterize exchanges, be-
tween one corporation only, ("simple redemptions") and one
or more persons who were shareholders of that corporation
immediately before the redemption ("veteran shareholders").
The provision determines whether the redemption of the
shareholder's stock transfers a sufficiently significant interest
in the corporation to the other veteran shareholders of the
corporation. But if X stock is exchanged for boot in the course
of an acquisitive reorganization, there will be a greater num-
ber of shareholders who have an interest in the assets of X at
the tail end of the transaction than there were at the begin-
ning of the deal. Specifically, Y's shareholders will have joined
the corporate enterprise formerly owned exclusively by X's
veteran shareholders. The application of section 302 to a hy-
pothetical redemption of only X's stock ignores the transfer
made to the veteran Y shareholders. This approach cannot
therefore properly reflect the nature and full extent of the in-
direct transfer effected by the redemption.

The errors that result from applying section 302 to the
issuing corporation are best illustrated by the following hypo-
thetical: \(^{101}\) Assume that X corporation has ten equally valua-
ble lines of business. If X were to simply redeem one half of
A's 80 shares, the exchange would not come near meeting the
requirements of section 302(b)(2)(B) or section 302(b)(2)(C).
The proceeds A received would therefore not qualify for treat-
ment as gain from the sale of an interest in property. The re-
demption of X's stock may be viewed in one of two ways: (1)
The traditional model of a redemption depicts A as relin-
quishing B a percentage of his interest in the assets, earnings

\(^{101}\) See note 8 and accompanying text.
and profits of each and every line of business that X owns, but in an alternative model (2) the situation in which A originally owns eight of X's ten lines of business and transfers some of them to B.

If all ten lines of business are equally valuable and will remain so, both examples fairly represent the transfer effected

102.

ILLUSTRATION #1

This 3/15 of X belonged to A before the redemption. Now, it belongs to B.

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ILLUSTRATION #2

This 3/15 of X belonged to A before the redemption. Now, it belongs to B.
by the redemption. A's surrender of one half of his stock may be viewed as the delivery to B of his deed to the small interests he relinquished to B. In exchange, A caused X to transfer to himself boot in which B also had an interest.

In both illustrations of a simple redemption, A remained in control of X after the redemption, despite the fact that the value of his investment in the reorganized corporation dropped by one-half. Since B was the only shareholder who could absorb the proportionate ownership of the corporate enterprise that A relinquished, A would have had to sell more than 75% of his stock to reduce his control of X by more than 50%. But if he sold 75% of his stock in the course of the reorganization, he would imperil the continuity of proprietary interest required for the transaction to qualify as a reorganization. Thus, A may find himself in the position of having to choose between the non-recognition benefits of a reorganization status, and the need to liquidate half of his investment at capital gain rates.

Revenue Ruling 75-83 unreasonably characterizes A's exchange though it were a "simple redemption." The ruling imposes the same stringent requirements on A when his "redemption" occurs in the more complicated context of a reorganization, even though thousands of Y shareholders are also available to absorb the proportionate ownership of the corporate enterprise that A gives up. Notwithstanding the fact that (1) a hypothetical redemption may reduce the value of A's corporate investment to less than 50% of what it was before, and (2) A's proportionate control over the assets remaining in the reorganized corporation, Revenue Ruling 75-83 would assign to him a hypothetical amount of control in excess of 50%. This would violate section 302(b)(2)(B), possi-

104. Under Treas. Reg. § 1.368-1(b) (1980), one of the requisites to a reorganization within the meaning of § 368(a) is a continuity of proprietary interest. The Service stated in Rev. Proc. 77-37, 1977-2 C.B. 568, that this requirement will be satisfied for ruling purposes if one or more former shareholders of the acquired corporation acquire together stock of the reorganized corporation, or a corporation controlling it equal to at least 50% of the value of all the outstanding stock of the acquired corporation on the date of the reorganization.
bly resulting in dividend treatment. Although section 302(b)(2)(B) is useful in preventing ephemeral reductions in the ownership of a single corporation from getting capital gain treatment, Revenue Ruling 75-83 focuses that provision's test on the wrong corporation, namely, the target corporation. This approach to "redemptions" made in the course of reorganizations creates the harsh result that A is treated as though he received a dividend.

On the other hand, the Service's application of the section 302 tests to the issuing corporations also creates a loophole for bail-outs. Shareholders having stock in both X and Y get favored treatment since the avoidance of dividend equivalency is conditioned on a proportionate reduction in ownership with respect to the shareholders of the target corporation only. For example, if A owned 80% of Y before the reorganization, the sale of one half or even three quarters of his relatively small holdings in X would result in a meaningless reduction in his overall corporate investment. Revenue Ruling 75-83 would effectively encourage A to separately incorporate a vegetable purchasing division to supply his Y Cor-

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105. **ILLUSTRATION #3**

<table>
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<th></th>
<th>B</th>
<th>A</th>
<th>Veteran Shareholders of Y</th>
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<tr>
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<td>9</td>
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Y's Lines of Business

X's Lines of Business

These 4 lines of business belonged to A before the hypothetical redemption. Now, they belong to the Veteran Shareholders of Y.

poration supermarket chain. He could plan to merge it into Y several years down the road and thereby bail-out earnings and profits at capital gains rates. Despite this result, Revenue Ruling 75-83 would find no dividend equivalency. The ruling's focus on a hypothetical proportionate reduction of control of the acquired corporation creates unduly harsh or unduly lenient results, depending on the existence or absence of common ownership.

The shortcomings of Revenue Ruling 75-83 are also particularly apparent when the shareholders of the target corporation receive what the ruling terms a "pro rata" distribution of boot. A pro rata redemption should always be treated as essentially equivalent to a dividend in the context of a single corporation, unless the requirements for a partial liquidation are met. This rule prevents the bailing out of E&P. An exchange of the acquired corporation's stock for boot in the course of a reorganization is, however, a different transaction and should not be analogized to a redemption by the acquired corporation. Several of the errors that result from such an approach would be particularly apparent if every shareholder in tiny X Corporation sold one-half of his stock to conglomerate Y for boot in the course of the merger. X's shareholders would each have (1) reduced the value of their corporate investment by 20 or even 50 percent; and (2) drastically reduced their proportionate control of X's assets because Y's veteran shareholders would absorb the interests relinquished via the exchange of stock for boot. Furthermore, the veteran shareholder of Y would control the entire enterprise. The requirements of section 302 would thus have been satisfied in principle. Nevertheless, Revenue Ruling 75-83 will only note that each "redeeming" shareholder's proportionate ownership has not dropped with respect to X's other former shareholder. Refusing, therefore, to admit the sale nature of the exchange of stock for boot, the Service would claim that the distribution of boot had the effect of a dividend.

The unreasonableness of the Service's position on "pro rata" exchanges of stock for boot is underscored by Revenue

107. Rev. Rul. 75-83 terms this transaction a "pro rata" distribution of boot.
Ruling 66-365. The Service admitted that not all pro rata hypothetical redemptions have the effect of a dividend. The ruling inexplicably allowed capital gain treatment so long as the exchange of stock for boot was necessary to avoid the issuance of fractional shares and was not separately bargained for. While the Service recognized that not all pro rata exchanges are equivalent to a dividend, the theoretical underpinnings for the conditions that the Service imposed on capital gain treatment remain unexplained.

ILLUSTRATION #4

108. B A

Veteran Shareholders of Y

These 4 lines of business belonged to A before the hypothetical redemption. Now, they belong to the Veteran Shareholders of Y.

X's Lines of Business

Y's Lines of Business

This line of business belonged to B before the hypothetical redemption. Now, it belongs to the Veteran Shareholders of Y.


110. Theoretically speaking, the position taken in Rev. Rul. 66-365 is erroneous. Under the meaningful reduction test, cash paid by the acquiring corporation to the shareholders of the acquired corporation in lieu of fractional shares will always have the effect of a dividend. The pre-reorganization, hypothetical redemption of stock in the acquired corporation will probably never come close to meeting the 20% requirement of § 302(b)(2)(C). But from a practical perspective, a contrary result would generate undesirable results, compelling the acquiring corporation to incur the inordinate expense and inconvenience of issuing and transferring fractional shares. See also Mills v. Commissioner, 331 F.2d 321 (5th Cir. 1964); Rev. Proc. 41, 1977-2 C.B. 574. The need for such an administrative exception to the dividend consequences that a strict "meaningful reduction" analysis entails, adds plausibility to the Service's position that § 302 principles should only be applied in appropriate cases. See Rev. Rul. 516, 1974-2 C.B. 121.
e. The Wright Test As a Solution

The Wright test\(^{111}\) attempts to deal with the same concerns that spawned Revenue Ruling 75-83, and in doing so it shifts the application of section 302 principles to changes in the ownership of the acquiring corporation. This approach has several advantages.

Under Revenue Ruling 75-83, A would have to sell sixty-one of his shares in X for boot in order to have his boot taxed at capital gain rates. If he sold any fewer shares for boot, he would fail the 50% requirement of section 302(b)(2)(B). Under Wright, by contrast, section 302(b)(2)(B) will pose no threat to him in his capacity as a Y shareholder. His ownership in the Y conglomerate, a corporation worth 100 times X, would not have reached the 50% control mark even if he had exchanged his X stock solely for Y stock. Therefore, he need only reduce by 20% the value of his corporate holding and his hypothetical control in Y.\(^{112}\) He would not be forced to sell more than sixteen shares for boot in order to get capital gain treatment merely because he had once been a controlling shareholder in X.

On the other hand, if A owned 80% of Y before the reorganization, exchange of sixty-one shares in X for boot would reduce his overall corporate ownership by less than 1% and would quite properly fail to meet the 20% requirement of section 302(b)(2)(C). Even if such a controlling shareholder were to simultaneously redeem enough Y stock to effect a 20% total reduction in ownership, his exchanges still would not qualify for capital gain treatment. He would fail the 50% requirement of section 302(b)(2)(B), imposed in the multicorporate context where it is meaningful. Similarly, if B owned 80% of Y, he could not obtain capital gain treatment on the exchange of less than 1% of his stock for boot. The loophole that Revenue Ruling 75-83 has left open for shareholders holding stock in more than one of the reorganizing corporations is thus closed by the Wright test.

Certain distributions that Revenue Ruling 75-83 inappropriately treats as pro rata dividends escape this treatment under Wright. For example, A and B may each sell one half of

\(^{111}\) See supra notes 82-83 and accompanying text.

\(^{112}\) See infra note 124. If more than one class of stock is outstanding, then capital gain treatment would also be conditioned on the additional safe harbor requirement of a 20% reduction in total stock ownership.
their stock to Y for cash and both get capital gain treatment. Having both suffered (1) a more than 20% reduction in the value of their stock and (2) a greater than 20% reduction in their control of the corporate enterprise, there is no reason why they should be denied the capital gain treatment that section 302 principle would afford either of them had the other not "redeemed" any stock in the course of the reorganization. Their redemptions will both be substantially disproportionate in the context of Y since the hypothetical exchange of one half of their Y stock for boot will not be a pro rata redemption of every Y shareholder's stock.\textsuperscript{113}

Each shareholder may be regarded as having sold so significant a portion of his investment that the exchanges would have qualified for capital gain treatment, if only the two shareholders had waited until the reorganization was old and cold before redeeming. Imposing dividend treatment when the reorganization and partial cash-outs occurred simultaneously serves no statutory purpose. \textit{Wright} prevents this injustice.

The \textit{Wright} approach appears to treat a shareholder more favorably to the extent that he owns a greater percentage of the target corporation. B who owns a mere 20% of X, must exchange at least five of his twenty shares for boot in order to avoid dividend equivalency. The demands put upon him will not change whether the "effect of a dividend" is determined under Revenue Ruling 75-83 or under \textit{Wright}.

As the net worth of Y increases with respect to X's net worth, the number of shares of X that A or C must exchange for boot in order to avoid dividend equivalency will drop and approach the number of shares whose sale would effect a 20% drop in the value of their holdings.\textsuperscript{114}

If C owned 60% of X, he would have to take at least $24 worth of his investment out of the corporate solution in order to get sale or exchange treatment applied to all his boot under Revenue Ruling 75-83, whatever the size of Y. But if X were merging into a Y that was one half the size of X, C would only have to sell $18 worth of his investment for boot; there would be a $6 or 25% reduction in the requirements he would have to meet to avoid dividend equivalency.

\textsuperscript{113} See supra notes 82-83 and accompanying text.
A, an 80% shareholder, may appear to be treated even more favorably than C under the Wright test. He would have to sell 61 shares for boot in order to get sale or exchange treatment under Revenue Ruling 75-83. But if X were to merge into a Y Corporation whose net worth was one half of X’s, A would only have to sell 28 shares of X for boot under

NOTE: This chart assumes that:
(1) Both X’s and Y’s shares have a fair market value of $1.00;
(2) X had 100 shares outstanding at the time of the merger;
(3) None of the “redeeming” shareholders of X owned any stock in Y before the merger.
Wright. He could thus retain $17, or 37% of the stock that Revenue Ruling 75-83 would have required him to liquidate in order to get capital gain treatment. Dividend equivalency could thus be avoided at a relatively small cost to the taxpayer.

Wright's "leniency" increases with the net worth of Y.\textsuperscript{115}

115.\[ P \left( N \right) = W \]

P = That percentage on "N" shares which may be retained in corporate solution under Wright without incurring dividend equivalency.

\[ N = \text{The minimum number of shares that must be exchanged for boot under Rev. Rul. 75-83 in order to avoid dividend equivalency.} \]

\[ W = \text{The number of dollars worth of investment that may be retained in corporate solution without incurring dividend equivalency because Wright was used rather than Rev. Rul. 75-83.} \]

NOTE: This chart assumes that:
(1) Both X's and Y's shares have a fair market value of $1.00;
(2) X had 100 shares outstanding at the time of the merger;
(3) None of the "redeeming" shareholders of X owned any stock in Y before the reorganization.
B, the 20% shareholder, will have to redeem five shares no matter how large or small Y is. But if Y's net worth is doubled, making it equal in value to X, C, the 60% shareholder, need only take sixteen shares out of corporate solution; the result is in a drop of 33% from the twenty-four share redemption requirement of Revenue Ruling 75-83. If Y's net worth increases to ten times that of X, 46% of the stock that C would have been required to sell under Revenue Ruling 75-83 may now be kept in corporate solution without any danger of dividend equivalency.

A's requirements drop from the sixty-one shares necessary under Revenue Ruling 75-83 to thirty-seven shares under Wright if Y is equal in value to X. Utilizing the Wright test enables A to keep in corporate solution 61% of the shares that he would have otherwise been required to liquidate under Revenue Ruling 75-83. If Y is worth ten times X, he may keep 73% of those shares in corporate solution.

The Service obviously objects to Wright's focus on changes in the ownership of the acquiring corporation. If the Wright approach is followed, there will clearly be a loss of revenue from certain reorganizations. The pool of shareholders in which the redeeming shareholder can drown the proportionate interest he relinquishes will always be smaller under Revenue Ruling 75-83 than it is under Wright. On the other hand, any potential losses may well be recouped by the increased dividend exposure to redeeming shareholders who have holdings in both corporations.

The Wright test does not unduly favor giving capital gain treatment to any shareholder. It simply avoids the tendency of Revenue Ruling 75-83 to quixotically discriminate against shareholders who own a large proportion of the target, and leave open loopholes for shareholders with holdings in both the target and the acquiring corporation. Wright, by contrast, treats redemptions in a manner that appears logically

116. "Corporate solution" refers to the reorganized corporation.
117. In Rev. Rul. 83, 1975-1 C.B. 112, the Service stated that it did not believe the McDonald case to be an "appropriate precedent" because the Service believed that the Tax Court had erred in distinguishing a long line of cases that had held that, regardless of which corporation makes the distribution, the amount of the dividend is measured by reference to the earnings and profits of the transferor.
118. See supra notes 100-106 and accompanying text.
119. See supra text accompanying notes 106-07.
consistent when viewed through the principles of section 302. It does so by following the opinion of most courts that section 302 and section 356(a)(2) are so intimately related that they should be read in pari materia.\textsuperscript{120}

There are historical and logical reasons for reading section 302 and section 356(a)(2) in pari materia. Both provisions were enacted before Congress settled on the policies for redemptions that are now clearly stated in the safe harbor provision, section 302(b)(2). In a section 302 context, the issuing corporation buys stock back from the shareholder. Similarly, under a section 356(a)(2) redemption, the issuing corporation repurchases stock from the shareholder. It does so by merging, in effect, into the corporation that exchanges a distribution of property for the stock surrendered.

Since section 302 was designed to characterize exchanges within a single corporation, and section 356(a)(2) was enacted to deal with exchanges made pursuant to a plan of reorganization, it would be anomalous were the latter provision the only one that ignored the reorganization in characterizing the boot. If a redemption is made before a reorganization and is characterized under section 302, the analysis must take the reorganization into account under \textit{McDonald}.\textsuperscript{121} Yet the approach to section 356(a)(2) taken in Revenue Ruling 75-83 ignores the reorganization. It disregards the fact that exchanges of stock for boot are often a condition \textit{sine qua non} for the reorganization and must be a part of the reorganization in order to be within the purview of section 356(a)(2). It is unreasonable to conclude that Congress decided to characterize them as though the reorganization did not occur.

\textit{Wright} rationally takes the reorganization into account by reading section 302 and section 356(a)(2) in pari materia, and thereby employing a hypothetical redemption test. But \textit{Wright}'s hypothetical redemption test could be criticized on technical grounds. In \textit{Shimberg}, where the Fifth Circuit refused to read section 302 and section 356(a)(2) in pari

\textsuperscript{120} Wright v. United States, 482 F.2d 600 (5th Cir. 1973), aff'g 29 A.F.T.R.2d 72-1466 (E.D. Ark. 1972); Ross v. United States, 173 F. Supp. 793 (Ct. Cl. 1959), cert. denied, 361 U.S. 875 (1959); Idaho Power Co. v. United States, 161 F. Supp. 807 (Ct. Cl. 1958), cert. denied, 358 U.S. 832 (1958). But see Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978) (holding that the principles developed in § 302(b)(1) cases are not always applicable to distributions under \textit{I.R.C.} § 356(a)).

\textsuperscript{121} See supra notes 47-50 and accompanying text.
materia, the court emphasized the fact that the taxpayer had never held any interest in the very corporation whose stock the district court considered hypothetically redeemed.122

This criticism belies the purpose behind a post-reorganization, constructive redemption test. In the context of a single corporation, a redemption analysis measures the changes in a shareholder's corporate ownership and determines whether there has been a substantial liquidation of his investment to justify treating the exchange of his stock for a distribution of property as a sale or exchange of an interest in property. If the redemption is effected by a single corporation, the interest in the corporation which is sold or exchanged is indirectly transferred only to other veteran shareholders of that corporation. If the constructive redemption is effected in a reorganization, it indirectly transfers interests to the veteran shareholders of the target and to the shareholders of the acquiring corporation as well. But it is the extent of the reduction in the redeeming shareholder's rights, as defined in Himmel v. Commissioner,123 that is the crucial factor under section 302 in determining the character of a redemption. This is true whether section 302 is applied to a redemption made by a single corporation, or to a constructive redemption made in the course of a reorganization.

The principles of section 302 should not be considered inapplicable to the reorganized corporation's purchase of a shareholder's stock merely because the shareholders of the acquiring corporation are also recipients of the interests indirectly transferred. The applicability of the redemption analysis does not hinge on the shareholder's actual, prehypothetical redemption ownership of stock or securities in the acquired corporation. The purpose of the redemption analysis is to measure the reduction in a shareholder's corporate ownership that is effected by the exchange of his stock for boot. The constructive redemption format facilitates that measurement.124

122. See supra note 67.
123. 338 F.2d 815 (2d Cir. 1964); see supra note 88.
124. The following is a proposed revision of § 356(a)(2) that would facilitate the measurement of "dividend equivalency."

356(a)(2)(A)—If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the gain recognized
Honesty and consistency in the administration of the tax laws would be served if the Service and the courts were to adopt the Eighth Circuit's approach. The Service would no longer feel constrained or authorized to abandon the hypothetical redemption approach, and strike out for automatic dividend treatment, whenever confronted by a reorganization of commonly owned corporations. Armed with a hypothetical redemption approach that would work well in all situations, the Service could be consistent without leaving a loophole for the reorganization of commonly owned corporations.

III. RATABLE SHARE OF THE UNDISTRIBUTED EARNINGS AND PROFITS OF THE CORPORATION ACCUMULATED AFTER FEBRUARY 28, 1913

A. Earnings and Profits Accumulated After February 28, 1913

Commentators seem to have generally agreed that the shareholder's ratable share of the "undistributed earnings and profits of the corporation accumulated after February 28, under paragraph (1) as is not in excess of his ratable share of the current and accumulated earnings and profits (other than earnings and profits accumulated before February 28, 1913) of each party to the reorganization in which he owned stock immediately prior to such reorganization. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.

(B)—For the purpose of subparagraph (A), the determination of whether the exchange has the effect of the distribution of a dividend shall be made by applying § 302 to a constructive redemption of stock that the distributee would have owned in the acquiring corporation immediately after the reorganization if there had been no exchange of stock for non-qualifying property. The non-qualifying property actually received by the distributee shall be deemed to have been received in consideration of stock or securities in the acquiring corporation equal in value to such non-qualifying property, according to the relative fair market values of the stock or securities that the distributee actually owns immediately after the reorganization.

(C)—For the purposes of this section, "non-qualifying property" means property not permitted by § 354 or § 355 to be received without the recognition of gain.

§ 318(b)(5) through (8) will be numbered (6) through (9), and the following provision will be added:

(5) section 356(a)(2) (relating to an exchange in a reorganization having the effect of the distribution of a dividend).

1913" does not include the current year's earnings and profits. Section 316(a) supports this position. It uses the very same words to state that the accumulated E&P have a different priority, in the case of a distribution under section 301, than the priority assigned to the E&P of the current taxable year.

It is puzzling that Congress chose to exclude the current year's E&P from the pool of earnings available for exchanges that have the effect of a dividend under section 356(a)(2). The possibilities for abuse or unduly lenient treatment, however, are not so rife as to justify the conclusion that the legislators redundantly used the term "accumulated" after "undistributed" for the sole purpose of emphasizing that Congress was concerned only with post-February 28, 1913 earnings. The more important problem, and one that requires greater consideration, is determination of which corporation's E&P will be used to determine the amount of taxable dividend under section 356(a)(2).

B. Which Corporation is "The Corporation?"

If a shareholder's exchange of stock or securities for boot has "the effect of a dividend" under section 356(a)(2), a portion of his boot may be taxed at dividend rates. That portion will be equal to the lesser of "his ratable share of the undistributed earnings and profits of the corporation," or his recognized gain. It is unclear which corporation is "the corporation" from which the shareholder is bailing out his share of the retained earnings. Since the reorganizing corporations' E&P accounts may differ, the proportion of the shareholder's gain that is taxable as a dividend will vary depending upon which corporation is identified as "the corporation."

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126. The argument that the "redundancy" was intentionally drafted into § 356(a)(2) to emphasize that only post-February 28, 1913 earnings were within its purview was made successfully for the first time in Vesper Co. Inc. v. Commissioner, 131 F.2d 200, 205 (8th Cir. 1942). The Tax Court subsequently followed this line of analysis. W.H. Weaver v. Commissioner, 25 T.C. 1067, 1083-84 (1956). See also James Armour v. Commissioner, Inc., 43 T.C. 295, 310 (1964), where the Tax Court added the corporation's current earnings and profits, without discussion, to the accumulated earnings and profits in determining the amount of boot that should be taxed as dividends.
1. **The "Transferor Analysis" and the "Total Corporate Pool Approach"**

Two interpretations of "the corporation" have been used by the courts.\(^{127}\) The majority viewpoint adopted by the Service, "the transferor analysis," is that the transferor or target corporation is the source of the shareholder's ratable share of E&P.\(^{128}\) One court has identified the combined corporate enterprise as "the corporation."\(^{129}\) Both approaches generate undesirable tax results.\(^{130}\)

The bulk of the problems resulting from the viewpoint that only the acquired corporation is "the corporation" arise in cases of common ownership. The sale of stock in only one corporation may be used to bail earnings out of another corporation. Nevertheless, the proponents of the Service's position generally feel that the 1924 Hypothetical leads to the conclusion that Congress was concerned with a bailout of the transferor's E&P only, and did not consider the possible bailout of those of the transferee as well.\(^{131}\) It is unclear why the example in the Committee Reports requires the conclusion that section 356(a)(2) applies only to a bailout from the transferor. If nothing else, the 1924 Hypothetical evidenced a Congressional understanding that a reorganization could be a device for the distribution by one corporation of another's earnings.

The fundamental flaw underlying the approach taken by

\(^{127}\) A third possible interpretation, i.e., viewing the acquiring corporation as "the corporation," has never been approved by the courts. Such an interpretation would inappropriately attribute to a shareholder, who had no interest in the acquiring corporation before the reorganization, the earnings and profits that it had made and accumulated before he acquired an interest in it.

\(^{128}\) See, e.g., American Mfg. Co. v. Commissioner, 55 T.C. 204 (1970). Rev. Rul. 75-83, 1975-1 C.B. 112; Ross, 173 F. Supp. at 798; Shimberg, 415 F. Supp. 832. Support for this position has also been drawn from Treas. Reg. § 1.381(c)(2)-1(c)(1) (1963). Samansky, supra note 20, at 35. The regulations state that the transferor's earnings and profits are to be computed by taking into account the amount of earnings properly allocable to the distribution. The regulation, however, could easily be interpreted in a manner consistent with the "prior ownership approach" for the computation of "ratable share." See infra notes 151-58 and accompanying text for an explanation of the term "prior ownership approach." The portion of the distribution properly allocable to the transferor's earnings and profits, rather than the entire distribution, should be taken into account in computing the transferor's earnings and profits.

\(^{129}\) Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).

\(^{130}\) See supra notes 104-107 and accompanying text.

the Service is that it attaches undue significance to the shareholder's self-interested identification of the stock being exchanged for boot. For example, if both X, the separately incorporated vegetable purchasing division, and Y, the supermarket chain of which B owned 8%, were acquired by the Z Corporation conglomerate, B could allege that he was exchanging only X stock for boot.\textsuperscript{182} Since X had very little E&P, B could get a quantum of capital gain treatment that otherwise would be denied him if Y's E&P were also included in "his ratable share of the undistributed earnings and profits of the corporation." In effect, he would get Y's accumulated earnings at capital gain rates by simply claiming that he was exchanging only X stock and no Y stock for the boot distribution he received from Z.\textsuperscript{183}

This result is contrary to the general presumption that a dividend distribution is presumed to be out of E&P to the full extent of the E&P available for distribution to the shareholder.\textsuperscript{184} When X and Y combined in the reorganization, B's share of Y's E&P was just as available for distribution to him as was his share of X's E&P. Interpreting "the corporation" as referring only to the acquired or transferor corporation disregards the full range of B's access to accumulated earnings. The "transferor analysis" allows the shareholder to freely determine the proportion of his boot that will be treated as a dividend allowing him to designate which of his shares are being exchanged for boot.\textsuperscript{185}

Equally erroneous results are obtained if "the corporation" is construed to mean the entire earnings and profits pool of the reorganized corporate enterprise ("the total corporate pool approach"). Anomalies arising from this construction would be particularly likely to occur in the absence of common ownership.

\begin{footnotes}
\item[132.] See supra note 8 and accompanying text.
\item[133.] B stands to benefit if X empties its tiny E&P account before the reorganization by distributing dividends. His X stock could thus serve as a means for bailing out a large proportion of Y's E&P even if the exchange had the effect of a dividend.\textsuperscript{132}
\item[135.] A redemption of only X stock long before the reorganization would also allow B to report the distribution at capital gain rates, but it might leave X without enough operating capital. If X borrowed the funds distributed in anticipation of the reorganization, the step transaction doctrine would bring the "redemption" within the purview of § 356(a)(2).
\end{footnotes}
For example, assume that X Corporation has been doing so badly that it has no retained earnings. Y Corporation, on the other hand, has accumulated E&P when it acquires X. If A were to exchange only ten of his shares in X for boot, the exchange would "have the effect of a dividend" even under the Wright test, limited to his ratable share of E&P. Under the "total corporate pool" interpretation, his "ratable share" would be computed by multiplying the combined enterprise's E&P account by his percentage of ownership in the combined enterprise. At least a nominal portion of his boot would be treated as a dividend because some of Y's E&P would be shifted to him.

This result is unfair because the one share that A exchanged for boot could have been redeemed at capital gain rates before the reorganization, since X had no accumulated E&P. A should not be charged with the earnings produced by the veteran Y shareholders' investment. It would be unfair and unreasonable to conclude that A had received a distribution of earnings, as a shareholder, from a corporation in which he held no interest until the very moment of the distribution.136

Earnings could also be unreasonably shifted away from A if the combined enterprise's entire pool of E&P were the "earnings and profits of the corporation." For example, X might have $25 of accumulated earnings when acquired by Y Corporation, which had no E&P. If A's "ratable share" of E&P is computed in the same manner as in the preceding example, the same E&P that X had before the reorganization must be multiplied by his percentage of ownership in the combined corporation. Because B's percentage of ownership in the combined corporation would necessarily be less than his percentage of ownership in X, his share of E&P would be dilated. His dividend exposure would therefore be reduced below the $20 attributable to his 80% ownership of X, and he would be able to bail some dividends out at capital gain rates.

The "total corporate pool" approach is unacceptable because of its potential for shifting E&P exposure to or away from the shareholder. The "transferor analysis" must also be

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136. By contrast, in the case of a "normal" dividend under § 301, the shareholder almost invariably acquires his ownership interest in the corporation before the distribution.
rejected because of the loopholes it creates. Neither approach consistently reflects the amount of earnings which the shareholder's pre-hypothetical redemption, stock investment generated.

2. Judicial Advances in the Search for the Source of E&P

Courts have generally adopted the "transferor analysis." Only the earnings of the transferor corporation enter into the computation of the shareholder's "ratable share of the undistributed earnings and profits of the corporation." While some courts have lamented the loophole that this approach opens for shareholders owning stock in both the transferor and transferee, no court has devised a solution. Rather, they have invariably left the matter to Congress.

The Fifth Circuit, in Davant v. Commissioner, attempted to close the loophole. In that case, the same taxpayers owned 100% of two corporations. They sold all their stock in one corporation to a straw man for an amount that they loaned to him. He subsequently caused his corporation to sell all its assets to the other corporation for cash, liquidated his corporation, and then used the proceeds to repay the loan from the shareholders. The Fifth Circuit recharacterized the transaction as a type D or F reorganization and found that the shareholders' exchange of stock for cash had the effect of a dividend.

The court refused, however, to limit the shareholders' divided treatment to the E&P of the transferor corporation. In one of its alternative holdings, the Fifth Circuit emphasized the complete identity of shareholders and stated that it was impossible to determine which corporation was "the corporation." Using both corporations' E&P accounts was therefore

137. See supra notes 128-35 and accompanying text.
140. See, e.g., American Mfg. Co., 55 T.C. at 231; Estate of Bell, 30 T.C.M. (CCH) 1221, 1225 (1975).
141. 366 F.2d 874 (5th Cir. 1966).
142. In its other alternative holding, the Fifth Circuit found that the distribution was out of the combined corporation's earnings and profits, was functionally unrelated to the reorganization, and was therefore governed by § 301 rather than § 356(a). Since there was a complete identity of shareholders, and the transferee corporation inherited the transferor's earnings and profits account, the result achieved by
appropriate. In developing its opinion, the court noted:

Before the reorganization the petitioners had two pockets with $900,000 in cash divided between them. After the reorganization, the petitioners had removed all that cash from both pockets, and it should not matter that before removing it completely they took it out of the right pocket and put it in the left.\textsuperscript{143}

Further, even if the transferor corporation was "the corporation," section 482 was available to allocate the necessary tax attributes to the transferor in order to prevent an evasion of taxes.\textsuperscript{144}

The decision was commendable for its attempt to deal with the common ownership loophole by finding that the "ratable share of the undistributed earnings and profits of the corporation" somehow included the E&P of the transferor as well. But the mechanisms employed were not suitable for general application.\textsuperscript{145} For example, section 482 could not apply to a bailout by B because X and Y were not under common control. Moreover, the notion that it is impossible to determine which corporation is "the corporation" can only be relied upon if there is complete identity of shareholders. Any disparity could make the combined E&P analysis inapplicable.

In American Mfg. Co. v. Commissioner,\textsuperscript{146} the Tax Court found itself confronted with common ownership and a boot distribution in a non-divisive, type D reorganization.\textsuperscript{147} In response to the Service's suggestion that Davant should control, the Tax Court detailed its reasons for rejecting the Fifth Circuit's analysis and for adhering to the generally accepted view that only the transferor's E&P were available for boot dividend treatment.\textsuperscript{148} However, the court erroneously relied on the court's analysis accurately reflected economic reality. See infra note 148. See also supra note 69.

\textsuperscript{143} Davant v. Commissioner, 366 F.2d at 889.

\textsuperscript{144} Id. at 890.

\textsuperscript{145} I.R.C. § 482 (1976) permits the Commissioner of Internal Revenue to re-allocate income and deductions among commonly controlled businesses if such an allocation is necessary to correctly reflect income.

\textsuperscript{146} 55 T.C. 204 (1970).

\textsuperscript{147} See B. Bittker & J. Eustice, supra note 29, chs. 13-14 (comprehensive discussion of non-divisive type D reorganizations).

\textsuperscript{148} In rejecting the Fifth Circuit's alternative holding, which had found the boot distribution "functionally unrelated" to the reorganization and thus within the
the conclusion, drawn from the 1924 Hypothetical, that section 356(a)(2) did not apply to bailouts from the transferee as well. The Tax Court also stated that a singular interpretation of "the corporation" was supported by reading section 354 and section 356(a)(2) together. While the court felt that this singular interpretation followed from the fact that section 354 speaks of a singular "transferor," the court did not explain why the "transferor" corporation in that non-recognition provision had to be "the corporation" from which section 356(a)(2) saw the shareholder bailing out dividends.

The Tax Court was not satisfied with the loophole that its transferor analysis created and it attempted to minimize the problem "which in reality exists only in certain limited situations." Having demonstrated the inadequacy of the Davant court's attempt to provide a rational method to measure the amount of dividend equivalency in cases of common ownership, the Tax Court concluded that Congress must provide the solution that the Tax Court's transferor analysis could not.

The Eighth Circuit's opinion, in Wright, hinted that it might not be necessary to wait for Congressional action. In determining whether the exchange of stock for boot had the effect of a dividend, the court rejected the transferor analysis. The Eighth Circuit went on to find instead that the distribution of boot should be viewed as having been made by the combined corporation in exchange for its stock that the shareholder would otherwise have received. Since the court held that the distribution was based on the combined capital accounts of both corporations, it seems logical to conclude that purview of § 301, the Tax Court noted that the "functionally unrelated" approach merely posed the question: "Could the property have been declared as a dividend before [the reorganization]?" If the answer were "yes," then the distribution would be characterized under § 301. Since this line of analysis renders § 356(a)(2) superfluous, the Tax Court declined to follow it. American Mfg. Co., 55 T.C. at 228. See supra note 142. In a recent article, however, the position is taken that pro rata distributions arising from the combination of identically owned corporations should be taxed under § 301. See Samansky, supra note 20. This approach seems reasonable, but it should be noted that it would require courts to ignore the example in the 1924 Committee Reports. Since the example indicated that the dividend, within gain, limitation was intended to apply to an abusive merger into a shell corporation, it would seem that the dividend, within gain limitation, rather than § 301, must, a fortiori, apply to a merger of two separate corporations, even if there is identical ownership and a pro rata distribution. But see supra note 69; see also supra note 124.
their combined earnings and profits account was the proper one to be charged with the boot distribution. The dimensions of the combined E&P account would therefore determine the amount of the shareholder's dividend treatment. Having found that the exchange did not have the effect of a dividend, the Eighth Circuit never reached the question of how to properly compute the stockholder's "ratable share" of the total combined E&P accounts of two reorganized corporations that were owned in different proportions before the reorganization.

3. The "Prior Ownership Approach" as a Solution

Among the Wright court's contributions to the development of dividend equivalency under section 356(a)(2) was its holding that the stockholder's ownership in the transferee must also be considered in determining whether an exchange had the effect of a dividend. The court recognized that a transferor analysis would ignore a common ownership and leave open a loophole for a bailout of E&P. The Fifth Circuit's earlier decision in Davant supplied the necessary step towards a rational computation of the amount of dividends distributed. The Fifth Circuit included the transferee corporation in the analysis which determines the amount of gain subject to dividend treatment. Neither Wright nor Davant, however, provided an adequate explanation of just how the E&P of the combined corporation could be used without creating anomalies.

These problems have a simple solution in the case of an acquisitive reorganization. "The corporation" should be interpreted as referring to the reorganized corporation. The shareholder's "ratable share" of the reorganized corporation's earnings and profits should be determined by: (1) applying the shareholder's percentage of ownership in each corporation, in which he held stock before the reorganization, to the earnings and profits account of that corporation, and (2) summing the products of the (several) multiplication(s) mentioned in clause (1).

This analysis, "the prior stock ownership approach," will prevent both the loopholes and the punitive treatment that

151. But see supra note 128 and accompanying text.
152. See supra notes 138-51 and accompanying text.
could be generated by using the "transferor analysis," or by using the "total corporate pool" approach. The "prior stock ownership" approach will consistently give an accurate measurement of the accumulated earnings that the shareholder is bailing out. In cases of common ownership, where the transferor analysis could shift E&P away from the shareholder, the prior ownership approach would instead charge him with earnings properly attributable to the stock he owned. For example, A's separately incorporated vegetable wholesaling division could no longer serve as a bailout device.\(^{153}\) Whether X merged into Y or vice versa, or both merged into Z, the amount of E&P available for A's dividend treatment would be the same.

In cases where the shareholder held stock only in the transferor, he would neither find himself charged with earnings made by another corporation, nor be able to shift away and dilute his dividend exposure through the reorganization.\(^{154}\) For example, if X had no E&P when it merged into a Y Corporation in which A held no stock before the reorganization, A would not be charged with dividend treatment on his boot merely because Y had E&P. Nor would the E&P available for his dividend exposure be reduced if Y had no E&P while X had a substantial amount.

From a purely linguistic standpoint, the "prior stock ownership approach" has both strengths and weaknesses. On the one hand, it assigns a literal and natural meaning to the words "ratable share." This construction reasonably treats the shareholder as though he draws his dividend from the E&P or reorganizing corporations to the extent of his ratable or proportionate interest in each of them. But the "prior stock ownership approach" may underemphasize Congress' use of "the corporation." Congress could simply have added to section 203(d)(2) the words: "ratable shares of the undistributed earnings and profits of the reorganizing corporation in which he held stock before the reorganization" if it intended to adopt this approach. The legislators' failure to include those words could be regarded as evidence that they did not view the claimed exchange of only X stock as a potential subterfuge that might be used to hide the removal of earnings from

Y as well.

There are two possible responses to these objections. First, the transferor analysis could be regarded as the only correct one. But, this would require the conclusion that the results discussed above were either intended by Congress, or simply escaped Congress' attention. Such conclusions would also ignore the fact that section 356(a)(2) was enacted for the specific purpose of preventing the use of the reorganization format as a device for the bailout of earnings at capital gain rates.

Alternatively, the prior stock ownership approach could be regarded as the better form of analysis. Even assuming arguido that it is a more liberal reading of the statute, it could be adopted for the simple reason that it generates a consistently just interpretation of the Code. The policy of assigning words their commonplace meaning should give way to the countervailing need for consistency, particularly when a statute is of uncertain meaning, as is the case here, and erroneous results would otherwise obtain.

Even if Congress was unaware that there could be a bailout of the transferee's E&P, as the Tax Court has claimed, and even if Congress simply did not know what it was doing when it enacted section 203(d)(2), as some commentators have suggested, Congress at least was vague enough to give the courts the freedom to interpret section 356(a)(2) without creating outrageous results. Courts should use that freedom even if they find the linguistic format of section 356(a)(2) somewhat disturbing. Mertens points out, "[i]n recent years, the courts have not felt bound to apply slavishly the literal phrasing of statutes when the clearly indicated purpose of the Congress seems to require a broader or narrower interpretation." Section 316 clearly expressed the broad Congressional intent that dividends should be taxed as such.

155. See, e.g., United States v. American Trucking Ass'n, Inc., 310 U.S. 534 (1940); A. L. Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935); DeSoto Sec. Co. v. Commissioner, 235 F.2d 409 (7th Cir. 1956); ABC Brewing Corp. v. Commissioner, 224 F.2d 483 (9th Cir. 1955).


158. Samansky, supra note 20, at 46; Shoulson, supra note 20, at 578-79.

159. 1 J. MERTENS, supra note 125, at § 3.04, 9.
to the full extent of the earnings and profits available for the shareholder's distribution. Courts should not frustrate that clearly stated intent without a good reason.

Thus, even if it is within the letter of section 356(a)(2) to bail earnings out of the transferee through an exchange of the transferor's stock, it is not within the spirit of section 356(a)(2). This triumph of form over substance was not within the intention of its makers and should not be allowed.

IV. CONCLUSION

Various tests have been set out by the courts and commentators for determining whether gain recognized as a consequence of a reorganization will be taxed at capital gain rates or be given dividend treatment. The automatic dividend rule ignores the sale approach while the test employed by the district court in Shimberg overemphasizes it. The former leads to harsh results, while the latter invariably results in dividend treatment. Applicability of a partial liquidation analysis will always be uncertain. Therefore, it is advisable to effect such a liquidation prior to the reorganization to avoid possible dividend treatment.

Revenue Ruling 75-83 recognizes that an exchange of stock in a reorganization can be either purely capital in nature or equivalent to a dividend. Its focus only on the redemption of the target corporation stock, however, leads to discriminatory treatment of the target corporation shareholders while it leaves a loophole for "bailing out" E&P to shareholders of both the target and acquiring corporations.

Wright, by contrast, treats redemptions in a manner which is logically consistent with section 302. The Wright court properly held that dividend equivalency should be determined by a post-reorganization, constructive redemption analysis under the principles of section 302. This approach was justified because the shareholders holding stock in similar or related corporations might find a loophole for the bailout of E&P if the separate-corporation transferor analysis were employed. Only the use of a multi-corporate framework enables a court to inquire whether the shareholder was bailing out E&P from the corporate enterprise, under the guise of a sale of part or all of his interest in one of its corporate facets. The Wright court's multi-corporate framework also avoids the anomalously harsh treatment that Revenue Ruling 75-83, based on a
transferor analysis, imposed on larger shareholders in the target corporation.

If a distribution to a shareholder who had an interest in more than one corporation has the effect of a dividend, the logic of the Wright decision requires that the amount of his dividend should be computed by reference to the E&P of all of the reorganizing corporations in which he held stock before the reorganization. This inference follows since the Wright test referred to the shareholder’s original, total combined stock ownership in determining whether he had received a dividend. It would therefore be unreasonable to limit the amount of his dividend, his “ratable share” of the undistributed earnings of “the corporation,” to the E&P of the designated transferor corporation.

Two tests are currently used for determining which corporate E&P’s will be used for dividend treatment. The transferor analysis ignores common ownership leaving a loophole for a bailout of E&P. The “total corporate pool” approach is unacceptable because of its potential for shifting E&P exposure to or away from the shareholder. The “prior stock ownership approach” to the determination of the shareholder’s “ratable share” of E&P, involves a reading of section 356(a)(2) that is no less literal than the transferor analysis approved by the Tax Court and the Service. On the other hand, even if the prior stock ownership approach is regarded as a more liberal reading of the Code, it is a necessary one which most accurately reflects the legislators’ intent.

Because the Wright test treats redemptions in a manner which is logically consistent with section 302, and the “prior stock ownership approach” most consistently reflects the amount of E&P which the shareholder’s stock investment generated prior to the hypothetical redemption, adherence to these rules will provide the most accurate measurement of “dividend equivalency.”

160. See supra text accompanying notes 132-33 (example of a shareholder designating only one corporation as the transferor. This misleading designation enabled him to bail earnings out of that corporation and another corporation he controlled by merging both corporations into an unrelated third corporation).