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STOCK DIVIDEND TAXATION UNDER THE TAX REFORM ACT OF 1969: EXPANSION OF AN OMINOUS PAST

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The Tax Reform Act of 1969[1] effects changes in the area of stock dividend taxation which mark an abrupt return to principles that, prior to their abandonment with the enactment of the *Internal Revenue Code of 1954*,[2] plagued the tax laws. Although stock dividends, generally, will continue to be treated as nontaxable,[3] the exceptions to this rule have been greatly expanded.[4] The recent changes are but another addition to the rich history surrounding the federal income taxation of stock dividends. This history has been characterized by a checkered legislative development which has occasioned a great amount of confusion in the courts. The difficulty apparent in the vacillations of Congress has

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1. Pub. L. No. 91-172 (Dec. 30, 1969), 83 Stat. 487. Hereinafter, the Tax Reform Act of 1969 will be referred to as the T.R.A. In addition, all citations of section numbers are to the *Internal Revenue Code of 1954* as amended by the T.R.A. unless otherwise indicated. Hereinafter, the *Internal Revenue Code of 1954* will be cited as I.R.C.

2. For an excellent comprehensive analysis of the impact of the T.R.A. on corporations and their investors, see Eustice, *Corporations and Corporate Investors*, 25 Tax L. Rev. 509 (1970). For an analysis of the effect of the T.R.A.'s capital gain and loss provisions on individuals, see Andrews & Freeland, *Capital Gains and Losses of Individuals and Related Matters Under the Tax Reform Act of 1969*, 12 Ariz. L. Rev. 627 (1971).

3. I.R.C. § 305(a).

4. *Id.* § 305(b) & (c).

been influenced by increasingly complex corporate capital structures designed to allow shareholders to receive equity appreciation under the guise of tax-free stock dividends. Congress' reaction in 1969, while recognizing the continued viability of the tax-free stock dividend concept, is a direct attempt to thwart taxpayer efforts to abuse its spirit.

Although the impact of the intricate framework of rules governing the taxability of stock dividends presented by new section 305 is felt at the shareholder level, the burden of coping with section 305 surfaces at the corporate level.[5] The magnitude of this burden is underscored by the penalty for failing to structure a stock dividend to receive nontaxable treatment—a tax imposed on shareholders when they have not received the cash to pay the tax. Indeed, a comprehensive understanding of the section is essential for individuals charged with the responsibility for corporate tax planning.[6] The purpose of this article is to aid in the development of such an understanding. The approach will be to trace the historical development of stock dividend taxation, discuss the reasons prompting the T.R.A. changes, develop a complete understanding of revised section 305 and analyze some of the difficult situations that are likely to arise under its operation.

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5. *See* H. GUTHMANN & H. DOUGALL, CORPORATE FINANCIAL POLICY 543-46 (4th ed. 1962).
6. The importance of such an understanding is emphasized by the following

HISTORICAL PERSPECTIVE

The passage of the sixteenth amendment in 1913 marked the beginning of the present day federal income taxing scheme by empowering Congress to tax an individual's income without apportionment among the states. Pursuant to this grant of authority, the Revenue Act of 1913 imposed a tax on corporate dividends.[7] Since the statute did not deal specifically with stock dividends, their taxability was soon questioned in *Towne v. Eisner*,[8] a case involving a dividend of common stock paid on the same class of common stock. The Court summarily held that such a dividend was not taxable to shareholders, reasoning that stock dividends were not within the taxing statute's general definition of income.

The Revenue Act of 1916 provided that the cash value of a stock dividend represented taxable income to the shareholder to the extent of the corporation's earnings and profits accumulated since March 1, 1913.[9] A challenge to the constitutionality of a tax imposed under this statute was presented to the Supreme Court in 1920 in the landmark case of *Eisner v. Macomber*.[10] Once again, the distribution in question involved a distribution of common stock on stock of the same class (where only common stock was outstanding), and the Court held a tax on such a distribution to be unconstitutional:

> A 'stock dividend' shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.
>
> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretion and accumulation have resulted from employment of his money and that of other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment. Having regard

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statement: "Directors in determining dividend policy should consider the tax aspects involved, in the interests of soundness, good shareholder relations, and their own potential personal liability for negligence or breach of fiduciary duty." H. HENN, LAW OF CORPORATIONS 693 (2d ed. 1970). Because of the potential for harsh tax consequences, it appears that the directors have the responsibility to reach corporate decisions only after a careful consideration of the tax consequences at the shareholder level.

7. Act of Oct. 3, 1913, ch. 16, § 2(A)(1), 38 Stat. 166.
8. 245 U.S. 418 (1918).
9. Act of Sept. 8, 1916, ch. 463, § 2(a), 39 Stat. 757.
10. 252 U.S. 189 (1920). For discussions of this case, see Powell, *Stock Dividends, Direct Taxes, and the Sixteenth Amendment*, 20 COLUM. L. REV. 536 (1920); Seligman, *Implications and Effects of the Stock Dividend Decision*, 21 COLUM. L. REV. 313 (1921).

> to the very truth of the matter, to substance and not to form, he has received nothing that answers the definition of income within the meaning of the Sixteenth Amendment.[11]

Congress responded to *Eisner v. Macomber* with a declaration in the Revenue Act of 1921 that a "stock dividend shall not be subject to tax,"[12] a provision that was clearly broader than the case required. The case had only decided that a dividend of common stock on the stock of the same class could not be taxed. Nevertheless, the tax-free status of stock dividends continued through successive revenue acts for fifteen years.[13]

In 1936, *Koshland v. Helvering*[14] influenced a significant contraction in the broad statutory proscription of stock dividend taxation. The taxpayer had purchased cumulative nonvoting preferred stock in 1924 and 1926, and had later received a voting common stock dividend on this stock. When the corporation redeemed the preferred stock in 1930, the Commissioner, in order to increase the amount of the taxpayer's gain resulting from the redemption, asserted that a portion of the taxpayer's original basis in the preferred stock must be allocated to the common stock. The Court, holding that there should be no allocation, recognized that the receipt of the stock dividend was a taxable event to the taxpayer:

> Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, representing the same *proportionate interest* in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest *different* from that which his former stockholdings represented he receives income. The latter type of dividend is taxable as income under the Sixteenth Amendment. Whether Congress has taxed it as of the time of its receipt, is immaterial for present purposes.[15] [Emphasis added.]

It is important to recognize an ambiguity in the Court's language which permeated stock dividend disputes following *Koshland*. Although the Court referred to a change in a stockholder's "proportionate" interest as being an important factor, it was not clear that such a change was an essential prerequisite to taxing a stock dividend. Instead, the Court said that a stock dividend was taxable when it gave the stockholder a "different" interest than his former stockholdings represented. The distinction between the two tests is illustrated by the following example. Assume

11. 252 U.S. at 211.
12. Act of Nov. 23, 1921, ch. 136, § 201(d), 42 Stat. 228.
13. *See* Act of June 2, 1924, ch. 234, § 201(f), 43 Stat. 255; Act of Feb. 26, 1926, ch. 27, § 201(f), 44 Stat. 11; Act of May 29, 1928, ch. 852, § 115(f), 45 Stat. 822; Act of June 6, 1932, ch. 209, § 115(f), 47 Stat. 204; Act of May 10, 1934, ch. 277, § 115(f), 48 Stat. 712.
14. 298 U.S. 441 (1936).
15. *Id.* at 445-46.

that a corporation with only common stock outstanding distributed preferred stock to its shareholders in proportion to the amount of common stock held by each. If a different interest test applies, the stock dividend would be taxable while, on the other hand, it would not be taxable if a proportionate interest test applies.[16]

The Revenue Act of 1936[17] attempted to eliminate the confusion created by *Koshland.* The act hedged by stating that a stock dividend was not taxable unless it constituted income within the meaning of the sixteenth amendment, thereby delegating to the courts the burden of distinguishing between taxable and nontaxable stock dividends. The following eighteen years were plagued by confusion in the courts over the acceptable dividing line between taxable and nontaxable stock dividends.[18]

The position taken by the Commissioner in *Helvering v. Griffiths*[19] is a testimonial to the rampant uncertainty existing after *Koshland.* The Commissioner argued that a stock dividend of common-on-common was taxable, contending that the theoretical basis of *Eisner v. Macomber* had been overruled by *Koshland,* but the Court refused to sustain the tax.[20] It reasoned that a reconsideration of *Eisner v. Macomber* was unnecessary since section 115(f)(1) of the Revenue Act of 1936, as reenacted in the *Internal Revenue Code of 1939* under which the suit was brought, had incorporated the *Eisner v. Macomber* doctrine.[21] Hence, the Court made it clear that a tax-free stock dividend category still existed. The scope of this category remained for a case-by-case definition.

The Supreme Court, recognizing the existing confusion, heard two companion cases in an effort to resolve the conflict. In *Strassburger v. Commissioner*[22] the sole shareholder of a corporation with only common stock outstanding had received a stock dividend consisting of 50 shares of nonvoting cumulative preferred. In *Helvering v. Sprouse*[23] the corpo-

16. *Compare* the opinion of the Court of Appeals *with* that of the Supreme Court in Strassburger v. Commissioner, 124 F.2d 315 (2d Cir. 1941) (different interest), *rev'd,* 318 U.S. 604 (1943) (proportionate interest).

17. Act of June 22, 1936, ch. 690, § 115(f)(1), 49 Stat. 1688.

18. *See, e.g.,* cases applying a "different interest" test: Strassburger v. Commissioner, 124 F.2d 315 (2d Cir. 1941), *rev'd,* 318 U.S. 604 (1943) (stock dividend of preferred on common where only common outstanding in hands of sole shareholder); Frank J. & Hubert Kelly Trust v. Commissioner, 38 B.T.A. 1014 (1938), *vacated,* 106 F.2d 1002 (8th Cir. 1939) (stock dividend of preferred on common held taxable). *See, e.g.,* cases applying a "proportionate interest" test: Sprouse v. Commissioner, 122 F.2d 973 (9th Cir. 1941), *aff'd,* 318 U.S. 604 (1943) (only voting and non-voting common outstanding; distribution of non-voting common stock dividend to the holders of both voting and non-voting common held not taxable to taxpayer holding only voting common prior thereto); Dreyfuss v. Manning, 44 F. Supp. 383 (D.N.J. 1942) (stock dividend of preferred stock to sole shareholder of common stock held not taxable). *See generally* 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 9.91 (1969).

19. 318 U.S. 371 (1943).

20. *Id.* at 404.

21. *Id.* at 380.

22. 318 U.S. 604 (1943).

23. *Id.* at 606.

ration had only voting and nonvoting common stock outstanding and distributed a nonvoting common stock dividend to the holders of each class; the taxpayer in question had owned only voting common prior to this distribution in which he received 200 shares of the nonvoting common. The Court found the stock dividends in both cases to be nontaxable, applying the proportionate interest rather than the different interest test and interpreting *Koshland* as follows:

> We held, in the circumstances there disclosed, that the dividend was income, but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary, the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.[24]

In retrospect, this language seems to have been clear enough to resolve the issue. The aftermath of the *Sprouse-Strassburger* cases, however, indicates that, either because of the Commissioner's persistence in asserting that the different interest test should be applied, or because of the inherent difficulties in distinguishing between the two tests in complex factual situations, the confusion continued until the enactment of the *Internal Revenue Code of 1954.*

The period between the *Sprouse-Strassburger* cases and the enactment of the *Internal Revenue Code of 1954* is personified by *Wiegand v. Commissioner*[25] which illustrates the complexity of distinguishing between the two tests. Wiegand Company had two classes of stock, *A* and *B*, outstanding. Class *A* was preferred stock with the following rights: exclusive voting, cumulative preference, participation after a stated payment of dividends on the class *B* stock, and a liquidation preference. The class *B* stock was nonvoting common. The company declared a 50 percent pro rata dividend of stock of the same class on each class. The effect of the stock dividend was to increase the preferential dividend requirement on class *A* shares by $12,000 annually and the number of class *A* shares entitled to liquidation preference by 2,000. Conversely, the participation right of the class *A* shares was delayed because of the distribution of additional class *B* shares to the class *B* shareholders. The Commissioner asserted that all shareholders had received taxable income and the Tax Court agreed.[26] On appeal, the Third Circuit Court of Appeals reversed on the ground that the shareholders' proportionate interests in the net value of the corporation were not changed by the stock dividend,

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24. *Id.* at 607-08.
25. 14 T.C. 136 (1950), *rev'd*, 194 F.2d 479 (3d Cir. 1952). *See also* Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954); Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951); Pizitz v. Patterson, 183 F. Supp. 901 (N.D. Ala. 1960); John A. Messer, Sr., 20 T.C. 264 (1953).
26. 14 T.C. 136 (1950).

stating that "[n]o changes whatsoever were effected in the strict legal rights of stockholders either *vis-a-vis* each other or the corporation."[27]

Stock dividend taxation underwent another reversal with the enactment of the *Internal Revenue Code of 1954*.[28] Undoubtedly perplexed by the types of problems characterized by *Wiegand*, Congress enacted section 305 declaring stock dividends to be nontaxable and rejecting the proportionate interest test.[29] The section did, however, provide two exceptions to the nontaxability rule: a distribution of a corporation's stock issued to discharge preference dividends for the preceding or current taxable year,[30] and a distribution that gave the shareholder the election to receive cash or other property.[31] Congress, desiring not to give everything away to the taxpayer, supplemented section 305 with section 306 which taints preferred stock received as a stock dividend and, generally, makes such stock taxable at ordinary income rates upon its subsequent disposition.

In comparison with the previous treatment of stock dividends, the new rules were simple and caused taxpayers little difficulty. Moreover, they gave taxpayers greater flexibility in designing and adjusting capital structures to allow tax-free stock dividends which would have been subject to attack under the pre-1954 rules. These capital readjustments generally followed one of two popular approaches. The first, labeled the "two classes of common stock plan," utilized a recapitalization to create two classes of common stock that shared equally in dividends. The distinguishing characteristic, however, was that one class would receive cash dividends while the other would receive stock dividends. Further, the class receiving stock dividends would be convertible into the other class at the option of the shareholder.[32] The other approach also involved a recapitalization. A new class of convertible preferred stock was created

27. 194 F.2d 479, 481 (3d Cir. 1952) (footnote omitted). The court explained that:

> Like many tax cases those at bar present a study in semantics, if not in metaphysics. It is true following the distribution that the B stock cannot receive its dividend until what now is more of the A stock has received its dividends. But the legal rights of the A and B have not been changed or affected. If we may employ a homely but nonetheless useful 'down-Delaware' phrase, the B stock, after the distribution, will eat lower down on the hog, but the hog has grown. The cuts, the proportional interests, of the A and the B remain the same.

Id. at 481 n.3. The Seventh Circuit reached a similar result in another case arising out of the same stock distribution. Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951).

28. Originally enacted as Act of Aug. 16, 1954, ch. 736, 68A Stat. 3.

29. Ch. 736, § 305, 68A Stat. 90 (1954).

30. *Id.* § 305(b)(1).

31. *Id.* § 305(b)(2).

32. *See generally* Levin, *New 305 Regs limit tax advantages of 2-class common stock, but alternatives exist*, 30 J. TAX. 2 (1969); *IRS attempts to stop 2-classes-of-common tax-saving plans; legality questioned*, 5 J. TAX. 178 (1956); *Two classes of stock: one gets cash, one stock dividends: a useful tax planning tool*, 4 J. TAX. 312 (1956).

and common shareholders were given the option of exchanging their common stock for the new class of convertible preferred. Although the convertible preferred received no cash dividends, it was convertible into common stock at an increasing conversion ratio. The increase in conversion ratio was often directly correlated with payments of cash dividends on the corporation's common stock.[33]

The Commissioner was concerned about these plans since a shareholder was given an election between equity appreciation and cash dividends. Accordingly, the Treasury issued proposed regulations in 1956 aimed at precluding the tax-free election present in such plans.[34] These regulations were severely criticized, however, as exceeding the statutory grant of authority to the Treasury.[35] As a result of this criticism, 12 years passed before they were officially adopted in revised but expanded form on January 10, 1969.[36] This criticism continued after their adoption in early 1969,[37] and was an influential factor during the drafting of the T.R.A. changes.

In view of the protracted transition rules of the T.R.A. changes,[38] the 1969 regulations have more than passing historical significance. In recognition of their continued importance, they should be studied carefully after it has been determined that the transition rules render the T.R.A. inapplicable to a particular stock distribution.[39] The 1969 regulations are similar in many respects to the T.R.A. provisions, except that they are not nearly as comprehensive. The questionable legality of the 1969 regulations, when coupled with their somewhat limited scope, set the stage for sweeping changes to be made by the T.R.A.[40]

STOCK DIVIDEND TAXATION IN GENERAL

Section 305(a) remains basically unchanged from the law existing prior to the T.R.A.:

> Except as otherwise provided in this section, gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock.

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33. For a general discussion of this plan, see Levin, *supra* note 32.
34. Proposed Treas. Reg. § 1.305-2, 21 Fed. Reg. 5104-05 (1956).
35. *See, e.g., IRS attempts to stop 2-classes-of-common tax-saving plans; legality questioned,* 5 J. TAX. 178 (1956).
36. T.D. 6990, 1969-1 CUM. BULL. 95. For arguments that these regulations are invalid, see Del Cotto & Wolf, *The Proportionate Interest Test of Section 305 and the Supreme Court,* 27 TAX L. REV. 49, 58-60 (1971); Metzer, *The "New" Section 305,* 27 TAX L. REV. 93, 141-42 (1971).
37. Levin, *supra* note 32, at 4-5.
38. For a discussion of the transition rules, see text accompanying notes 257-66 *infra.*
39. For an analysis of the scope and application of these regulations, see Del Cotto & Wolf, *supra* note 36, at 53-60; Levin, *supra* note 32.
40. H.R. REP. No. 91-413, 91st Cong., 1st Sess., pt. 1, at 113 (1969) [hereinafter cited as H.R. REP. No. 91-413]; S. REP. No. 91-552, 91st Cong., 1st Sess. 151 (1969) [hereinafter cited as S. REP. No. 91-552].

This general rule preserves the rationale of *Eisner v. Macomber*[41] and defers the moment of taxation until the subsequent sale of the shares. Hence, it is necessary to consider the various tax attributes that attach to stock received in a nontaxable stock dividend.

The first inquiry relates to the determination of the basis of the stock received. Section 307 provides that a portion of the adjusted basis of the old stock must be allocated to the new stock[42] and grants authority to the Commissioner to prescribe regulations specifying the method of allocation. The regulations state that "the basis of the stock with respect to which the distribution was made shall be allocated between the old and new stocks . . . in proportion to the fair market values of each on the date of distribution."[43] The allocation is a simple matter if the old stock was all acquired at the same time and at the same price. For example, consider the situation where a shareholder held 100 shares of stock with an aggregate basis of $6,000 and received a 50 percent nontaxable stock dividend. If the fair market value of the old and new shares was $60 per share at the time of distribution, the allocation would be made as follows:

Aggregate fair market value (150 Shares $\times$ \$60) = \$9,000

Allocation to new stock $= \dfrac{\$3{,}000}{\$9{,}000} \times \$6{,}000 = \$2{,}000$

Allocation to old stock $= \dfrac{\$6{,}000}{\$9{,}000} \times \$6{,}000 = \$4{,}000$

Where the old stock was purchased at various times and at different prices, the allocation becomes somewhat more complex. In Revenue Ruling 71-350,[44] the Service takes the position that the shareholder must compute the basis of the dividend stock by allocating the basis of each particular lot to the proportionate amount of dividend stock attributable thereto; if he can identify his various purchases and has so allocated the dividend stock, he may determine which stock dividend shares he has sold. On the other hand, if the dividend stock sold cannot be identified with any particular lot, the ruling states that "the stock sold is charged against the dividend stock attributable to the earliest of such lots."[45]

An example will illustrate the mechanics of the foregoing ruling. Assume the shareholder holds the following common stock at the time of a nontaxable stock dividend:

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41. See text accompanying note 11 *supra*.
42. "Old stock" refers to the shareholder's stock with respect to which the stock dividend was distributed. "New stock" refers to the stock that is distributed as the stock dividend.
43. Treas. Reg. § 1.307-1(a) (1955). This regulation further provides that the date for determining the fair market value of the stock is the date of actual distribution rather than the stock dividend record date.
44. 1971 INT. REV. BULL. No. 31, at 15. *See* Keeler v. Commissioner, 86 F.2d 265 (8th Cir. 1936); Rev. Rul. 56-653, 1956-2 CUM. BULL. 185.
45. Rev. Rul. 71-350, 1971 INT. REV. BULL. No. 31, at 15-16.

	Shares	Basis
Lot 1	10	$ 500
Lot 2	25	1,500
Lot 3	15	600
	50	$2,600

If the corporation then pays a stock dividend of one share of common for each share of common stock outstanding, the shareholder will receive 50 new shares. Assume further that the shareholder subsequently sells 25 of the new shares. If this stock cannot be identified with any particular lot, the ruling requires that its basis be determined on a first-in-first-out (FIFO) method. Accordingly, 10 shares will be identified with Lot 1 and assigned a basis of $25 each ($500 ÷ 20 shares) and the remaining 15 shares will be identified with Lot 2 and assigned a basis of $30 ($1,500 ÷ 50). On the other hand, if the shareholder identifies the dividend stock sold as that received with respect to Lot 2, all the 25 shares sold will have a basis of $30 each.

Once the basis of the dividend stock has been ascertained, the holding period for the dividend stock must be determined. Section 1223(5) provides that where the stock basis is determined under section 307[46] the holding period for the new stock is the same as the holding period for the old stock with respect to which the stock dividend was paid. Presumably, the rationale of Revenue Ruling 71-350 also has application to the determination of the holding period.[47] Hence, where there are several lots of stock which have been purchased at different times, the stock attributable to each lot should take on the holding period of the particular lot or the FIFO method should apply.[48]

A remaining consideration relates to the effect of a nontaxable stock dividend on the distributing corporation. As might be anticipated, the distribution is not considered to be a distribution of earnings and profits,[49] and no gain or loss is recognized by the corporation as a result of the distribution.[50] In addition, it seems well settled that costs incurred in issuing a stock dividend are not deductible under section 162 as ordinary and necessary business expenses; instead, they are nondeductible capital expenditures.[51]

46. See text & notes 41-44 *supra*.

47. Since the revenue ruling requires that dividend stock sold be identified with the particular lots with respect to which it is distributed, it seems reasonable to assume that the dividend stock should take its holding period from the particular lot with which it is identified. See text following note 44 *supra*.

48. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.61, at 66 n.115 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

49. I.R.C. § 312(d)(1)(B).

50. *Id.* § 311(a)(1).

51. General Bancshares Corp. v. Commissioner, 326 F.2d 712 (8th Cir.), *cert. denied*, 379 U.S. 832 (1964); Rev. Rul. 60-254, 1960-2 CUM. BULL. 42. It should also be observed that under principles of corporate law the amount so capitalized

Section 305(a) is straightforward and, accordingly, presents few interpretive problems. Fortunately, there are cases and administrative interpretations which remove any ambiguity present in its language. Several observations, however, are necessary to place the provision in its proper perspective. The question is whether certain transactions, while not in form stock dividends, should be treated as such, and it appears that in certain circumstances form may prevail over substance. For example, a declaration of a cash dividend where there exists an agreement among shareholders to use the cash to purchase additional shares of the corporation's stock has been held to be a cash dividend.[52] In addition, a declaration of a cash dividend raises a presumption that the dividend is to be paid in cash rather than in stock.[53] From a tax planning standpoint, this potential problem is avoided by careful drafting of the declaration and related resolutions so that there is no inference that the corporation was considering payment of a cash dividend. Further, the actions of corporate management should not be inconsistent with the payment of a stock dividend.

The Commissioner has, on occasion, asserted that a distribution of treasury stock could not qualify as a stock dividend. This assertion, however, has been laid to rest by the refusal of courts to recognize any difference between a distribution of treasury stock and a distribution of a new issue.[54] The regulations have adopted this construction.[55]

It should be emphasized that section 305 only applies to distributions by a corporation of its own stock and has no application to a distribution by a corporation of stock of another corporation.[56] Such a distribution is a distribution of property taxable under section 301.[57] Further, distributions of the corporation's bonds must be distinguished from stock dividends. Normally such bonds are classified as property, and section 305 is not applicable to their distribution.[58] This result occurs

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is unavailable for the payment of dividends in the future. 11 W. FLETCHER, PRIVATE CORPORATIONS § 5362 (perm. rev. ed. 1971).

52. Makransky v. Commissioner, 35 B.T.A. 395 (1937). The court accorded strong weight to a corporate resolution which authorized the payment of a dividend and accepted the offer to purchase additional shares of stock. The court also recognized the significance of some shareholders electing to retain the cash received as a dividend, thereby increasing the proportionate interests of those shareholders electing to purchase additional stock. *Id.* at 402.

53. Henry Vogt Mach. Co. v. United States, 39 F.2d 986 (Ct. Cl.), *cert. denied*, 282 U.S. 861 (1930). *See generally* 1 J. MERTENS, *supra* note 18, at § 9.95.

54. Bruckheimer v. Commissioner, 46 B.T.A. 234 (1942); James Kay v. Commissioner, 28 B.T.A. 331 (1933).

55. Treas. Reg. § 1.305-1; Proposed Treas. Reg. § 1.305-1(a), 36 Fed. Reg. 5221 (1971).

56. This is apparent from the language of the statute since it applies to distributions "of the stock of a corporation made by such corporation to its shareholders with respect to its stock." I.R.C. § 305(a).

57. *Id.* §§ 301, 317(a). *Cf.* Rev. Rul. 70-521, 1970-2 CUM. BULL. 72, which provides that a distribution by a corporation of short-term transferable rights to acquire stock in another corporation is a distribution of property with the meaning of section 301.

58. I.R.C. § 317(a); Treas. Reg. § 1.301-1(d) (1955). Section 317(a), de-

even if the bonds are convertible into common stock.[59] It is also clear that a corporation's distribution of its own stock to shareholders in their nonshareholder capacities, for example as a compensation payment to an employee shareholder,[60] is not covered by section 305.[61]

Finally, one further potential distribution of stock which could be covered by section 305 relates to the typical earn-out provision present in many acquisitive reorganizations where, for example, the earnings potential (and its consequent effect on the selling price) of the acquired corporation is subject to considerable uncertainty.[62] The usual earn-out clause provides that the purchase price shall be adjusted by distributing additional stock based upon satisfactory subsequent earnings performance of the acquired corporation. The Commissioner in the proposed regulations has indicated a willingness to exempt such agreements from section 305,[63] and it seems likely that this will be the ultimate position taken in the final regulations.[64] This situation is fundamentally different from a stock dividend distribution since the subsequent distribution of stock rep-

fines "property" for purposes of section 301 to be "money, *securities,* and any other property; except that such term does not include stock in the corporation making the distribution." (Emphasis added.) Bonds ordinarily come within the meaning of securities.

59. This must necessarily be the result unless convertible bonds are considered to be stock within the meaning of section 305(a). The term "stock" is defined to include rights to acquire the corporation's stock, but the definitional provision is silent with regard to convertible securities. I.R.C. § 305(d)(1). When melded with the fact that the definition of property includes securities, this silence appears to foreclose the argument that convertible securities fall within the meaning of stock. See I.R.C. § 317(a). Moreover, another definitional provision of section 305 states that, for purposes of section 305(b) and (c), the term "shareholder" includes a holder of convertible securities. I.R.C. § 305(d)(2). The fact that the statute specifically includes convertible securities within one context (the definition of shareholder) and fails to refer to them within the other context (the definition of stock) lends credence to the argument that convertible securities are not within the meaning of stock. *See* Proposed Treas. Reg. § 1.305-5(a), 37 Fed. Reg. 4965 (1972); Eustice, *supra* note 2, at 550 n.43. *But cf.* Proposed Treas. Reg. § 1.305-7 (b)(1), 37 Fed. Reg. 4966 (1972).

60. The effect of this is to eliminate any possibility for distributing the compensation tax-free to the employee under the guise of section 305. The amount of the compensation income in such a situation is determined by the fair market value of the stock distributed. I.R.C. § 61(a)(1); Treas. Reg. § 1.61-2(d)(1) (1957). The further question that arises is whether the corporation will be allowed a *deduction* for the stock distributed as compensation. Section 1032 provides that no gain or *loss* results to a corporation on a disposition of its own stock for money or property, and Treas. Reg. § 1.1032-1(a) (1956), interprets this section as covering a distribution of stock as compensation. Rev. Rul. 62-217, 1962-2 Cum. Bull. 59, however, states that the fair market value of a corporation's treasury stock distributed as compensation "is deductible as a business expense in accordance with the provisions of section 162(a)." The ruling indicates that the nonrecognition provisions of section 1032(a) have no effect upon a business deduction that is otherwise allowable. To similar effect see Rev. Rul. 69-75, 1969-1 Cum. Bull. 52 (previously authorized but unissued shares).

61. *See* Commissioner v. Fender Sales, Inc., 338 F.2d 924 (9th Cir. 1964), *cert. denied,* 382 U.S. 813 (1965); Bittker & Eustice ¶ 7.61, at 65 & n.113.

62. *See generally* Metzer, *supra* note 36, at 117-19.

63. Proposed Treas. Reg. § 1.305-1(c), 36 Fed. Reg. 5221 (1971).

64. The legislative history of the T.R.A. clearly indicates that section 305 is not intended to apply to adjustment of purchase price. H.R. Rep. No. 91-413, at 115; S. Rep. No. 91-552, at 154.

resents an adjustment of the purchase price rather than a distribution on the shares originally paid in the transaction; thus, the subsequent distribution cannot be said to have been made by the acquiring corporation "with respect to its stock" as required by section 305(a). One caveat seems to be in order, however—the earn-out period probably must be limited to a reasonable time. Otherwise, it could be used effectively to circumvent section 305.[65]

EXCEPTIONS ACTIVATING SECTION 301

While the general rule of section 305(a) permits nontaxable stock dividend distributions, the beginning phrase—"Except as otherwise provided in this section"—is loaded like a spring gun and when triggered can have a devastating effect upon the shareholders in its path. It paves the way for a number of important exceptions to the general rule and mandates the shareholder to review all of these exceptions, contained in section 305(b), as a prerequisite to receiving tax-free treatment. This discussion will explore the ramifications of this phrase which has the potential, to the extent of the section 305(b) exceptions, of activating section 301 and bringing a stock dividend distribution within the latter's ambit. New section 305(b) incorporates the exceptions existing under prior law and adds several broad new ones. Although only one of the new exceptions specifically mentions the requirement of an increase in proportionate interest,[66] they are generally aimed at taxing distributions which increase the proportionate interests of shareholders.[67] Hence, they attempt to im-

65. The proposed regulations offer an example which would allow the exemption from section 305 in a situation in which the earn-out period was 3 years. Proposed Treas. Reg. § 1.305-1(c), 36 Fed. Reg. 5221 (1971). If significantly longer earn-out periods were tolerated, this would seem to sanction situations which section 305(b) was designed to avoid. For example, if in an "A" reorganization, I.R.C. § 368(a)(1)(A), the acquired corporation's shareholders were paid with stock convertible into the acquiring corporation's common stock and were given a ten year contingent stock earn-out arrangement, the Commissioner might attack the arrangement as an effort to allow some shareholders to take equity appreciation while others were receiving cash or property dividends. *Cf.* the discussion of "two classes of common stock plan" in text accompanying note 32 *supra.* The regulation dealing with preference dividends under pre-T.R.A. section 305 (ch. 736, § 305, 68A Stat. 90 (1954)) indicated that stock distributed pursuant to an earn-out provision would not result in a taxable stock dividend provided that such distribution represented an adjustment of the consideration transferred in the exchange, and all such distributions were made within five years after the date of the exchange. Treas. Reg. § 1.305-3(b)(4) (1969). As a practical matter, it seems likely that many earn-out provisions will be limited to a five year period because the Commissioner will not issue a favorable ruling with respect to "A," "B" or "C" reorganizations unless all of the stock involved will be issued within five years of the reorganization. Rev. Proc. 67-13, 1967-1 CUM. BULL. 590; Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232. *See generally* Murphy, *Contingent Share Reorganizations,* U. So. CAL. 1969 TAX INST. 255, 259-77 (1969).

66. I.R.C. § 305(b)(2)(B).

67. The only exception under which a stock dividend can be taxable without an increase in proportionate interests is section 305(b)(4) which applies to distributions of stock with respect to preferred stock. For example, a distribution of preferred-on-preferred to the sole shareholder of a corporation is taxable under a

pose a tax currently on those shareholders who receive equity appreciation in lieu of periodic cash dividends.

The exceptions, when applicable, destroy the nontaxable nature of stock dividends and activate the dividend machinery of section 301.[68] In such a case the amount of the distribution[69] (presumably the fair market value) resulting from the stock dividend is taxable[70] to the shareholder to the extent of the distributing corporation's earnings and profits;[71] the excess of the amount distributed over earnings and profits first reduces the adjusted basis of the stock with respect to which the stock dividend was paid (but not below zero)[72] and, to the extent it exceeds such adjusted basis, it is treated as gain from the sale or exchange of property.[73] The basis of the stock dividend in the hands of the shareholder (presumably the fair market value)[74] is determined under section 301(d) while the holding period is measured from the date of receipt.[75] No gain or loss on such distribution is recognized by the distributing corporation,[76] and its earnings and profits are decreased by the fair market value of the stock distributed.[77]

The potential effect of the section 305(b) exceptions is amplified by the broad statutory delegation of rule-making power to the Treasury under section 305(c). The approach will be to present a brief overview of section 305(c) since an awareness of this provision is a necessary prerequisite to a comprehensive understanding of the section 305(b) exceptions. An exception-by-exception analysis will then follow with examples illustrating the various applications.

Disguised Stock Dividend Rule: Section 305(c)

From a tax planning standpoint, probably the most ominous new rules are found in the disguised stock dividend provision, section 305(c). In that section, Congress required the Commissioner to promulgate regu-

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literal reading of the statute although this result is contrary to the teaching of *Strassburger*. *See* text accompanying note 22 *supra;* Del Cotto & Wolf, *supra* note 36, at 62.

68. I.R.C. § 305(b). The prologue to this subsection provides: "Subsection (a) shall not apply to a distribution by a corporation of its stock, and the distribution shall be treated as a distribution of property to which section 301 applies . . . ."

69. *See* I.R.C. § 301(b); Treas. Reg. § 1.301-1(d) (1955); Treas. Reg. § 1.305-2(c)(1) (1960).

70. For the partial exclusion of dividends received from the gross income of an individual and the intercorporate dividends received deduction, see, respectively, I.R.C. §§ 116, 243. *See also* I.R.C. §§ 244-247.

71. *Id.* §§ 301(c)(1), 316(a).

72. *Id.* § 301(c)(2).

73. *Id.* § 301(c)(3).

74. Treas. Reg. §§ 1.301-1(h)(1) to -1(h)(2)(i) (1955).

75. There is no provision for "tacking" of holding periods in cases of taxable as opposed to nontaxable stock dividends. *See* I.R.C. § 1223(5).

76. *Id.* § 311(a).

77. *Id.* § 312(a); Treas. Reg. § 1.312-1(d) (1955).

lations under which transactions having the effect of increasing proportionate interests are subject to the rules of section 305. It provides:

> For purposes of this section and section 301, the Secretary or his delegate shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction.

Section 305(c) does not render a particular event taxable. Instead, it operates to transform the event into a constructive stock dividend to those shareholders whose proportionate interests in the earnings and profits or assets of the corporation are increased by the event, and requires them to run the gauntlet of section 305(b).[78] The section's operation is largely dependent upon the Commissioner's administrative pronouncements. The proposed regulations suggest several detailed examples of situations in which the provision is operative, but a critical question remaining from a tax planning point of view is whether these examples will be all-inclusive. In this regard, it is worth noting that the examples in the proposed regulations are limited to the specific situations delineated in section 305(c), and the statutory language pertaining to transactions having a similar effect is merely reiterated rather than interpreted.[79] It seems that this can be interpreted as an indication that the Commissioner is likely to assert that the provision has application to situations not exemplified in the regulations.

Assuming that the final regulations will adopt a similar approach,[80] this raises the threshold question whether the Commissioner has authority to engage taxpayers in this modified form of "Russian roulette." Taxpayers can make a convincing argument that, at the minimum, the statute, by including the word "shall," places an obligation upon the Commissioner to provide guidance in the regulations regarding the meaning of "transaction . . . having a similar effect" and that, in the absence of at

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78. Accordingly, a shareholder deemed to receive such a constructive stock dividend must determine whether any of the exceptions of section 305(b) apply to the dividend. If no exception applies, then the distribution is nontaxable under the mandate of section 305(a). *See* Proposed Treas. Reg. § 1.305-7(a), 37 Fed. Reg. 4966 (1972).

79. *Id.* §§ 1.305-3(e), -5(c), 36 Fed. Reg. 5223-26 (1971). *Id.* §§ 1.305-5(c), -7, 37 Fed. Reg. 4965-66 (1972).

80. The final regulations are currently being drafted by the Commissioner, but he is unable to estimate when they will be issued. Letter from Robert A. Bley, Assistant Director, Legislation & Regulations Division, Internal Revenue Service, Washington, D.C., to Lawrence R. Wilson, Oct. 21, 1971. On March 7, 1972, the Commissioner issued revised proposed regulations. 37 Fed. Reg. 4964 (1972).

least some specificity in the regulations, the Commissioner is without further authority to act. Because of the stock dividend provision's complexity and the stringent burden placed upon taxpayers to comply, this would appear to be a reasonable obligation to impose upon the Commissioner. Though this argument may be valid, the tax planner should attempt to assess all possibilities apparent in the broad language of section 305(c) in order to give wise counsel. Accordingly, this article will attempt to determine the ultimate scope of this provision in the context of the various section 305(b) exceptions.

Distributions in Lieu of Money: Section 305(b) (1)

The section 305(b) (1) exception provides that a distribution which is payable either in stock or in property at the election of *any* shareholder shall be treated as a distribution of property to which section 301 applies[81] with respect to *all* shareholders even if all shareholders elect to receive stock.[82] Nor does it matter whether the election was exercised before or after the declaration of the dividend.[83] This exception is a continuation of a provision existing under the *Internal Revenue Code of 1954*[84] but now has less significance because of the T.R.A.'s enactment of the far-reaching rule of new section 305(b) (2).[85]

The following example illustrates the simplest operation of this exception. A corporation declares a $10 dividend per common share outstanding payable in either cash or common stock of equivalent value and the shareholders are given an election as to the form of payment. Section 305(b) (1) clearly applies to activate section 301 and the amount of the distribution is $10 whether the shareholder is paid in cash or stock. Of course, if the property offered to the shareholder is other than cash

81. I.R.C. § 305(b)(1).

82. Although this consequence is not absolutely clear under the statute, several factors indicate a strong likelihood that the final regulations will adopt such a rule. First, a similar statutory provision existed prior to the T.R.A. and the regulations thereunder imposed a like rule. Ch. 736, § 305(b)(2), 68A Stat. 90 (1954); Treas. Reg. § 1.305-2(a)(2)(i) (1955). Further, the proposed regulations impose the same rule. Proposed Treas. Reg. § 1.305-2(a)(1), 36 Fed. Reg. 5222 (1971). Moreover, if the same approach is taken in the final regulations, an attack upon the regulation on the ground that it is beyond the legislative grant of authority to the Commissioner is not likely to be successful. The reenactment doctrine would probably apply; thus, the reenactment of the statutory provision would be considered to be at least a tacit approval of the existing regulation. *See* Helvering v. Winmill, 305 U.S. 79, 83 (1938). This would be true as to all of the final 1969 regulations to old section 305(b)(2), particularly in view of the legislative history to new section 305. *See* H.R. REP. No. 91-413, at 113; S. REP. No. 91-552, at 151.

It should be noted that the shareholders do not receive any increase in their proportionate interests in the assets or earnings and profits of the corporation in the event that they all elect to receive stock. Nevertheless, the stock distribution is a distribution of property to which section 301 applies.

83. I.R.C. § 305(b)(1) (parenthetical phrase).

84. Ch. 736, § 305(b)(2), 68A Stat. 90 (1954).

85. *See* text following note 87 *infra*.

and the shareholder elects to receive such property, the amount of the distribution may vary depending upon whether the shareholder is an individual or a corporation.[86] This exception is unambiguous and is not likely to create difficulty in its application on a distribution-by-distribution basis.[87]

Disporportionate Distributions: Section 305 (b)(2)

Section 305(b) (2) provides that a distribution shall be treated as one to which section 301 applies:

> [i]f the distribution (or a series of distributions of which such distribution is one) has the *result* of (A) the receipt of property by some shareholders, *and* (B) an increase in the proportionate interests of other shareholders in the assets or earnings and profits of the corporation. [Emphasis added.]

This is probably the most important of all the section 305(b) exceptions, and the following analysis will attempt to illuminate its basic principles.

1. *The Two-Prong "Result" Requirement.* Two distinct prerequisites must occur under the section 305(b) (2) exception before section 301 applies—the receipt of property by some shareholders, and a distribution of stock (actual or constructive) to other shareholders with the effect of increasing their proportionate interests.[88] To illustrate this requirement, assume that a corporation having two classes of common stock, *A* and *B*, with identical rights distributes class *B* stock to class *B* shareholders and makes no distribution to class *A* shareholders. This distribution would be a nontaxable stock dividend because of the absence of a property distribution despite the fact that it effects an increase in the proportionate interests of class *B* shareholders. If, however, the corporation also distributes a cash dividend to class *A* shareholders before or after the distribution of the stock dividend, the section 305(b) (2) exception is activated and section 301 applies.[89] The obvious practice which this provision is designed to thwart is the "two-class common stock plan" which has been utilized in the past by some corporations to give shareholders a choice between equity appreciation and cash dividends.[90] There can be little doubt as to the section's application in this classic situation.

The proposed regulations embellish the meaning of the exception in other contexts. An interesting provision in the proposed regulations provides that where there is more than one class of stock outstanding, each class of stock is to be considered separately in determining whether a

86. I.R.C. § 301(b)(1)(A) & (B). *See, e.g.*, Proposed Treas. Reg. § 1.305-2 (b) Ex. (1), 36 Fed. Reg. 5222 (1971).
87. For a more detailed discussion of this exception, see Metzer, *supra* note 36, at 101-05.
88. I.R.C. § 305(b)(2).
89. See text following note 102 *infra* for a discussion of the applicable time spans between the two distributions.
90. See text preceding note 32 *supra.*

shareholder has increased his proportionate interest in assets or earnings and profits of the corporation.[91] Further, it is stated that "individual shareholders of a class of stock will be deemed to have an increased interest if the class of stock as a whole has an increased interest in the corporation."[92] This provision, apparently proposed for administrative convenience, has potential for harsh results. For example, if a shareholder owns shares of both classes of equity stock in the same proportion, a distribution of stock on one and equivalent cash on the other will not change the shareholder's overall proportionate interest since the increase in proportionate interest of one class resulting from the stock distribution is offset by the decrease in the proportionate interest of the other class. Nevertheless, the stock dividend will be taxable under the mandate of the proposed regulations.[93]

Where a corporation has two classes of stock, class *A* common and class *B* nonconvertible preferred, a distribution of class *A* common to the common shareholders and cash to the preferred shareholders will not be taxable to the common shareholders because it fails to effect an increase in their proportionate interest in the assets or earnings and profits of the corporation.[94] The tax consequences may be different if the preferred is participating preferred.[95] It appears that this additional factor may cause the stock dividend to be taxable since the common shareholders as a class would thereby receive a right to greater earnings before the preferred began to participate.[96] Another variation of these facts should be

91. Proposed Treas. Reg. § 1.305-3(b)(6), 36 Fed. Reg. 5222 (1971).
92. *Id.* at 5223.
93. The Seventh Circuit, presented with a similar situation prior to the enactment of the *Internal Revenue Code of 1954*, held that the shareholder could not be taxed upon such a transaction. Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951). Since the tax, if applicable, is imposed upon the shareholders individually, it seems that each shareholder should be viewed individually to determine if he has received a proportionate interest increase.
94. *See* Proposed Treas. Reg. § 1.305-3(e) Ex. (2), 36 Fed. Reg. 5223 (1971).
95. A participating preferred has a right to participate with another class of stock in further dividends distributed after the usual preference is paid. *See* H. Henn, *supra* note 6, at 664-65.
96. *See* Tierney, *Proposed Regs under Section 305 amplify Treasury's tough posture on stock dividends*, 35 J. Tax. 86, 87 (1971). For example, assume a participating preferred class of stock has a right to a $5 per share preferred dividend and then after $10 per share is paid on the common, the preferred class has the right to participate equally per share with the common in any further dividend payments. Further, assume that the corporation has outstanding 1,000 shares of participating preferred and 2,000 common shares. Within this capital structure, if corporate management decides to pay $37,000 in dividends for the year, the distribution will be as follows:

	Preferred	Common
Payments Before Participation		
Preferred Stock (1,000 shares × $5)	$5,000	
Common Stock (2,000 shares × $10)		$20,000
Participation for Remaining $12,000		
Preferred Stock		
$\frac{\text{1,000 Pref. Shares}}{\text{3,000 Total Shares}} \times \$12{,}000$	4,000	

considered. Suppose class *B* nonconvertible preferred stock is distributed to common shareholders[97] while other class *B* preferred is outstanding and current in dividends. Because the liquidation and dividend preferences of this dividend stock increase the common shareholders' proportionate interest in the corporation's assets and earnings and profits, the proposed regulations provide that the dividend paid in preferred stock is taxable.[98]

One further observation must be made relating to the application of this exception within a capital structure of common and preferred stock. If the preferred is convertible into common, a payment of a cash dividend on the convertible preferred and a payment of a common stock dividend on the common will result in the stock dividend being taxable under section 301 unless the conversion ratio of the convertible preferred is increased to prevent dilution of the conversion privilege.[99] The revised

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Common Stock		
$\frac{\text{2,000 Comm. Shares}}{\text{3,000 Total Shares}} \times$ \$12,000	———	8,000
	\$9,000	\$28,000

The effect of a stock dividend upon the foregoing is to increase the amount of future cash dividends which must be paid on the common stock before the preferred stock begins to participate as well as to dilute the participation rights of the preferred stock. Hence, it appears that such an increase in the common shareholder's interest may be enough to cause section 305(b)(2) to apply. For the possibility that the participation right of the preferred must be of substance in the particular facts and circumstances (including the earnings and growth history) of the distributing corporation in order for the increase in proportionate interests to occur, see Proposed Treas. Reg. § 1.305-5(a), 37 Fed. Reg. 4965 (1972).

97. Whether a corporate distribution may dilute the preferred shares will be resolved under the applicable state law. ARIZ. REV. STAT. ANN. § 10-152.01(A) (Supp. 1971-72) provides:

> Every private corporation organized for profit shall have the power to create and issue shares of stock. Every such corporation shall have the power to create and issue one or more classes of shares, with such designations, preferences, privileges and voting powers or restrictions or qualifications thereof as the articles of incorporation . . . or any amendment of the articles of incorporation . . . provides.

Hence, it appears that a distribution of preferred stock to common shareholders would be legal in Arizona if the corporation's articles of incorporation sanction such a distribution.

98. Proposed Treas. Reg. § 1.305-3(e) Ex. (3), 36 Fed. Reg. 5223 (1971). This example further provides that a distribution of a new class of preferred stock which is totally subordinated to the outstanding preferred would not be a distribution to which section 301 applies. *Id.*

99. Proposed Treas. Reg. § 1.305-3(e) Ex. (13), 36 Fed. Reg. 5224 (1971). It should be noted that an increase in the conversion ratio solely to prevent the dilution that might otherwise result from stock dividends with respect to stock into which the convertible stock may be converted does not constitute a taxable constructive stock dividend with respect to convertible preferred stock. I.R.C. § 305(b)(4). For amplification of what constitutes a "full adjustment" in preventing dilution by stock dividends see Proposed Treas. Reg. § 1.305-3(d) (1) & (5), 37 Fed. Reg. 4964-65 (1972).

Another significant change made by the T.R.A. is that convertible securities are now treated as outstanding stock for purposes of applying sections 305(b) and (c). I.R.C. § 305(d)(2). This means that a corporation with interest bearing convertible debentures outstanding cannot issue a nontaxable stock dividend unless the debentures are protected from dilution by stock dividends. See text following note 256 *infra*.

proposed regulations provide that the distributing corporation may elect to make the appropriate adjustment in the conversion ratio and, hence, there will be no increase in proportionate interests. Generally, such election must be made by the earlier of either three years after the stock dividend or when the aggregate stock dividends, for which adjustment has not been made, total 3 percent of the stock outstanding on the date of the first such stock dividend,[100] and the distributing corporation complies with stipulated reporting requirements.[101]

2. *Series of Distributions Provision.* The parenthetical phrase included in the section 305(b) (2) exception—"or a series of distributions of which such distribution is one"—deserves discussion. Initially, the question is whether there must be a nexus between the distribution of property and the distribution of stock. The proposed regulations offer guidance by stating that the distributions need not be a part of a plan designed to increase the proportionate interests of shareholders.[102] Hence, they take the position that the ultimate result is enough—a receipt of property by some shareholders and an increase in the proportionate interests of other shareholders—even if the two distributions are independent and unrelated.

The analysis of distributions is eased by a three-year rule suggested by the proposed regulations.[103] This rule provides that where the distribution of cash or property occurs more than three years after the stock distribution, or where the stock distribution occurs more than three years after the cash or property distribution, the exception of section 305(b) (2) will not apply unless the distributions are made pursuant to a plan.[104] This three year rule, while helpful in most situations, creates a procedural problem for the recipients of a stock dividend which precedes a distribution to other shareholders in a succeeding taxable year. For example, a corporation having two classes of common stock, *A* and *B*, distributes a common stock dividend to class *A* shareholders on January 1, 1972, and a cash dividend to class *B* shareholders on June 30, 1974. The class *A* shareholders are placed in a precarious position at the time they file their 1972 federal income tax return because the tax status of their stock dividend is not ascertainable without a knowledge of the nature of future cor-

100. Proposed Treas. Reg. § 1.305-3(d)(2) & (3), 37 Fed. Reg. 4965 (1972).
101. *Id.* § 1.305-3(d)(4), 37 Fed. Reg. 4965 (1972).
102. Proposed Treas. Reg. § 1.305-3(b)(2), 36 Fed. Reg. 5222 (1971).
103. *Id.* § 1.305-3(b)(4), 36 Fed. Reg. 5222 (1971). The Treasury Department had proposed a 12-month rule for establishing the nexus between the property and stock distributions. *Technical Explanation of President's Tax Reform Proposals*, 56 Stand. Fed. Tax Rep. No. 20, at X-2 (April 23, 1969). It is significant that no such objective standard was statutorily sanctioned. *See* Tierney, *supra* note 96, at 86. The 3-year rule contained in the proposed regulations, however, may have been suggested by the Senate's de minimis rule which applied to all distributions made within a 36-month period ending on the date of the stock distribution under review. S. Rep. No. 91-552, at 154. This de minimis rule was not enacted as a part of the T.R.A.
104. Proposed Treas. Reg. § 1.305-3(b)(4), 36 Fed. Reg. 5222 (1971).

porate distributions to common shareholders. Shareholders, unwilling to be penalized for a lack of clairvoyance, will likely opt for nontaxable stock dividend treatment. When the cash dividend is paid in 1974, however, the result may be that the earlier treatment was erroneous. The path which the Commissioner will follow to remedy this dilemma is unclear; hopefully, the final regulations will eliminate this potential problem.

A further gloss is added to the meaning of "a series of distributions" by the following statement in the proposed regulations:

> [T]here is no requirement that the shareholders receiving cash or property acquire the cash or property by way of a corporate distribution with respect to their shares, so long as they receive such cash or property in their capacity as shareholders, if there is a stock distribution which results in a change in the proportionate interests of some shareholders and other shareholders receive cash or property.[105]

In its simplest form, the language makes taxable a stock dividend which is followed by a non pro rata redemption of some of the dividend stock. A broader application is suggested, however, by the following illustration taken from the proposed regulations.

> For example, if a corporation makes a stock distribution to its shareholders, and pursuant to a prearranged plan with such corporation, a related corporation purchases such stock in a transaction to which section 304 applies from those shareholders who want cash, the requirements of section 305(b)(2) are satisfied.[106]

Preliminarily, it seems clear that section 305(b)(2) does not—and was not intended to—apply within the section 304 context when the same person owns all of the outstanding stock of two (brother-sister) corporations. Assume that *A* owns 100 percent of the stock of *X* and *Y* Corporations, *X* Corporation distributes a stock dividend and *A* immediately sells the dividend stock to *Y* Corporation. Here, it is clear that although he has received property (as required by section 305(b)(2)(A)) in the sale-treated-as-a-redemption-distribution under section 304(a) (1), he has not increased his proportionate interest and, in any case, is not an "other" shareholder (as required by section 305(b)(2)(B)). Moreover, the

105. *Id.* § 1.305-3(b)(3), 36 Fed. Reg. 5222 (1971).

106. *Id.* Section 304 applies to two types of stock purchases. First, it applies "if (A) one or more persons are in control of each of two corporations, and (B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control." I.R.C. § 304(a)(1). A further application exists "if (A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and (B) the issuing corporation controls the acquiring corporation." *Id.* § 304 (a)(2). For purposes of this section, control is defined as ownership of at least 50 percent of the corporation's voting stock or at least 50 percent of the total value of all classes of stock. *Id.* § 304(c)(1). If section 304(a)(1) applies, then the property received is treated as a distribution in redemption of the acquiring corporation's stock.

"other" shareholder prerequisite of that section should not be considered satisfied by *Y* Corporation becoming a shareholder of *X* Corporation as the result of the sale because the "increase" of proportionate interest referred to there seems to be founded on the assumption that the party benefiting by such "increase" was already a shareholder prior to the transaction. In any event the question is probably academic[107] because the latter sale-redemption proceeds would be subject to section 301 even if the earlier stock dividend was nontaxable under section 305(a).[108]

Where there is not sole ownership of both corporations the situation is different. Assume that *A* and *B* each own 50 percent of the stock of both *X* and *Y* Corporations; *X* Corporation distributes a stock dividend and *A* sells his dividend shares to *Y* Corporation. Again, section 304(a) (1) would treat this sale as a redemption of *A*'s stock in *Y* Corporation. In view of the prearranged plan it might be asserted that the stock dividend distribution had the "result" (even though somewhat far removed) of *A* receiving property (in the redemption distribution) and *B* indirectly increasing his proportionate interest in *X* Corporation due to the fact that *B* owns 50 percent of *Y* Corporation, and thus one-half of the *X* Corporation dividend stock now held by *Y* Corporation.[109] There may be some doubt, however, that this indirect increase is the type of increase in proportionate interest required by section 305(b) (2) (B); if it is not, then the stock dividend would not be governed by section 305(b) (2).

On the other hand, assume *A* owns 50 percent of the stock of *X* and *Y* Corporations, *B* owns the remaining 50 percent of the stock of *X* Corporation and *C* owns the remaining *Y* Corporation stock. If *X* Corporation pays a stock dividend and *A* sells his dividend stock to *Y* Corporation, the sale will be treated as a redemption of *A*'s stock in *Y* Corporation

107. The question might not be considered academic if the stock dividend distribution and the sale-redemption occurred in different taxable years of *A*, and in the prior year *A* was in a much higher tax bracket than in the later year. As time elapses between the stock dividend and the sale-redemption, however, the more difficult it would be for the Commissioner to assert that it was part of a "prearranged plan" as required by the proposed regulation. The Commissioner might also have to contend with the statute of limitations on assessment as to the prior year. *See* I.R.C. § 6501(a). Finally, *Y* Corporation (the acquiring corporation) might have insufficient earnings and profits at the time of the sale-redemption to cause dividend treatment. *See* I.R.C. §§ 301(c)(1), 304(b)(2)(A), 316(a).

108. By virtue of section 304(a)(1) the sale of the *X* Corporation dividend stock by *A* to *Y* Corporation would be treated as a redemption of *Y* Corporation stock thereby activating section 302. Under the constructive stock ownership rule of section 318(a)(2)(C), *A* would be deemed the owner of the *X* Corporation dividend stock he had previously sold to *Y* Corporation. *See* I.R.C. §§ 302(c)(1), 304(b)(1). Since he owned 100 percent of the *X* Corporation stock both before and after the redemption, the exceptions of section 302(b) would not apply. *See* United States v. Davis, 397 U.S. 301 (1970). Consequently, the redemption distribution would be subject to section 301. I.R.C. §§ 302(a) & (d).

109. The constructive stock ownership rules of section 318 do not apply in determining the increase in proportionate interest required by section 305(b)(2)(B) because they are not "expressly made applicable" by a provision of section 305. *See* I.R.C. § 318(a).

under section 304(a)(1). Section 305(b)(2) should not apply in such a situation, however, because there has been no increase in *B*'s proportionate interest in *X* Corporation. The *X* Corporation shares are still outstanding even though they are then owned by *Y* Corporation (and by *A* and *C* indirectly).[110] Hopefully, the ambiguities existing in this proposed regulation will be eliminated before it becomes final.[111]

The two-pronged property receipt and proportionate interest increase requisites within the framework of the "series of distribution" language of section 305(b)(2), may be satisfied so subtly as to give rise to unexpected results. Thus, a distribution which is treated under another part of section 305(b) as a distribution of property to which section 301 applies might, at least technically, satisfy the receipt of property criterion under section 305(b)(2)(A). Hence, if such a distribution is coupled with a distribution of stock which increases other shareholders' proportionate interests in the corporation's assets or earnings and profits, section 305(b)(2) may operate to convert the latter stock distribution into one to which section 301 applies. This potential application is illustrated by the following example. Assume that a corporation having two classes of stock, class *A* common and class *B* nonconvertible preferred, distributes a preferred stock dividend on both classes of stock. Section 305(b) (4) clearly requires the distribution of preferred-on-preferred to be treated as a distribution of property to which section 301 applies. Further, the distribution of preferred-on-common may be a distribution to which section 301 applies within the meaning of section 305(b)(2), since the preferred shareholders have been treated as receiving property and the common shareholders' proportionate interests have been increased by the receipt of the preferred.[112]

3. *The Amount Taxable.* One further problem likely to arise with the application of the 305(b)(2) exception relates to the amount of the stock dividend which is taxable. The statute and proposed regulations imply that once the two events occur—receipt of property by some shareholders and an increase in proportionate interests of other shareholders—the entire stock dividend is taxable.[113] There is a situation, however, in which this is not the proper result. Thus, assume that a corporation with two identical classes of common stock, *A* and *B*, declares a dividend of two shares of class *A* per share of class *A* outstanding, and one share of class *B* plus $10 per share of class *B* outstanding. The two requisite

110. See text preceding note 107 *supra* as to whether *Y* Corporation or *C* is an "other" shareholder in this situation. See text & note 109 *supra* as to the issue of whether indirect ownership comes within the concept of proportionate interest.
111. *See* Tierney, *Proposed Regs. under 305(c) may create unexpected taxable stock dividends*, 35 J. TAX. 184, 186-87 (1971).
112. *See* Proposed Treas. Reg. § 1.305-3(e) Ex. (3), 36 Fed. Reg. 5223 (1971).
113. I.R.C. § 305(b)(2); Proposed Treas. Reg. § 1.305-3(a), 36 Fed. Reg. 5222 (1971).

events have occurred and the class *A* shareholders have increased their proportionate interest in the corporation's assets and earnings and profits to the extent of one share per share held. Under a literal reading of section 305(b) (2), the Commissioner might assert that all stock and cash received by both classes are taxable.[114] The proper amount of the taxable dividend, however, should be the $10 per share received by class *B* shareholders and the fair market value of one share received by the class *A* shareholders since, to the extent each class received a stock dividend, there would be an offsetting effect. Support for this conclusion may be drawn by analogy from an example in the proposed regulations dealing with section 305(b)(1).[115] That example provides that where a corporation distributes one share of stock per share outstanding and allows an election between an additional share or the equivalent cash, the amount of the distribution to which section 301 applies is that subject to the election. Although there is no comparable proposed regulation under section 305(b) (2), the rationale supporting the proposed regulation under section 305(b) (1) should apply equally to section 305(b (2). This is yet another uncertainty which, hopefully, will be clarified by the final regulations.

4. *Cash in Lieu of Fractional Shares.* Concomitant with most stock dividends are payments of cash in lieu of fractional shares.[116] Since these payments in cash result in the receipt of cash by some shareholders and a minute increase in the proportionate interests of other shareholders, it would be arguable, particularly in view of the legislative history,[117] that they warrant treating the entire distribution as one to which section 301 applies. The Treasury promptly settled this question by promulgating a temporary regulation which provides that payments in lieu of fractional shares will not render an otherwise nontaxable stock dividend taxable if the purpose of such payments "is to save the distributing corporation the trouble, expense, and inconvenience of issuing and transferring fractional shares . . . and not to give any particular group of shareholders an increased interest in the assets or earnings and profits of the corpora-

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114. Proposed Treas. Reg. § 1.305-1(b)(1), 36 Fed. Reg. 5221 (1971). This conclusion is reached by deduction since the proposed regulations fail to provide an exception for such a situation while they make an analogous exception applicable under section 305(b)(1). See text & note 115 *infra*.

115. Proposed Treas. Reg. § 1.305-2(b) Ex. (1), 36 Fed. Reg. 5222 (1971).

116. Fractional shares often result when stock dividends are paid on other than a one-for-one basis. For example, if a stock dividend is declared of one share for every five outstanding, a shareholder owning 102 shares will be entitled to 20.4 shares of dividend stock. State statutes frequently authorize the distribution of cash in lieu of fractional shares in order to facilitate such transactions. *See* H. HENN, *supra* note 6, at 298-99.

117. The Senate had provided for a de minimus exception to the application of section 305(b)(2) where the current distribution, plus all prior distributions made to a class of shareholders during a 36-month period ending on the date of the current distribution, did not increase their proportionate interest by more than one-tenth of one percent. S. REP. No. 91-552, at 154. This exception was eliminated by the conference committee, however. H.R. REP. No. 91-782, 91st Cong., 1st

tion."[118] A proposed regulation, in addition to reiterating the foregoing, provides that such a valid purpose will be presumed if the total amount of cash distributed annually in lieu of fractional shares is 5 percent or less of the total fair market value of the stock distributed.[119]

That proposed regulation also states that the shareholder shall treat the fractional shares as if they had been distributed and then redeemed by the distributing corporation so that the treatment of the cash received in lieu of fractional shares will be determined under section 302.[120] The effect of this is to treat the cash received as a cash dividend under section 301 unless the redemption qualifies for exchange treatment under section 302(b), which is highly unlikely.[121]

5. *Interplay With Section 305(c).* Section 305(c), which creates a constructive stock dividend in certain situations substantially broadens the scope of the section 305(b) (2) exception. An analysis of these situations is essential to a complete understanding of the exception. When section 305(c) applies within 305(b) (2), the constructive distribution of stock must result in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders in order to activate the exception.[122]

The first event delineated in section 305(c) is a change in conversion ratio. This event activates section 301 within the context of section 305(b) (2) when a corporation having two classes of stock, class *A* common and class *B* common which is convertible into class *A* common, pays a cash dividend on the class *A* stock and increases the conversion ratio of the class *B* convertible common, or when such a corporation pays a cash dividend on the class *B* convertible common and concurrently decreases the conversion ratio of that class of stock. In the former case, the constructive stock dividend is received by the class *B* shareholders while in the latter case it is received by the class *A* shareholders.[123] Hence, it can be concluded that provisions requiring conversion ratio adjustments related to distributions of *cash* dividends may now be less desirable because of the foregoing tax consequences. On the other hand, it should be recalled that adjustment of conversion ratios to protect the conversion privilege from dilution by *stock* dividends paid will usually be required to preserve the nontaxable status of such stock dividends.[124]

Sess. 309-10 (1969).

118. Temporary Treas. Reg. § 13.10(a)(2) (1970).

119. Proposed Treas. Reg. § 1.305-3(c)(1), 36 Fed. Reg. 5223 (1971).

120. *Id.* § 1.305-3(c)(2), 36 Fed. Reg. 5223 (1971).

121. Section 301 will normally apply unless the distribution is not essentially equivalent to a dividend. I.R.C. §§ 302(a), 302(b)(1), 302(d). *See* Rev. Rul. 69-202, 69-15, 1969-1 CUM. BULL. 95. *Cf.* Rev. Rul. 66-365, 1966-2 CUM. BULL. 116, for a discussion of fractional shares issued in lieu of cash in a reorganization.

122. I.R.C. § 305(b)(2).

123. Proposed Treas. Reg. § 1.305-3(e) Ex. (7), 36 Fed. Reg. 5223 (1971); *id.* § 1.305-7(b)(1), 37 Fed. Reg. 4966 (1972).

124. See text accompanying notes 98-101 *supra*.

Section 305(c) mentions two types of events which are closely related—a change in redemption price and a difference between redemption price and issue price. These categories may have a somewhat subtle significance within the context of section 305(b) (2) since once they operate to create a taxable constructive stock dividend, the constructive stock dividend may be treated as a distribution of property which satisfies one phase of the section 305(b) (2) two-prong test.[125] Hence, if a taxable constructive stock dividend is deemed to have occurred by virtue of section 305(c) and one of the 305(b) exceptions, the subsequent distribution of a stock dividend which increases the proportionate interests of stock dividend recipients could be taxable.[126]

As an illustration of the operation of the foregoing, assume that a corporation is organized with class *A* common and class *B* convertible preferred stock. The preferred is entitled to no dividends, convertible into class *A* stock at a set ratio (not subject to adjustment in the event stock dividends or rights are distributed to class *A* shareholders), issued for $50 per share and redeemable in 5 years for $75 per share. Section 305(c) treats the excessive redemption premium[127] as a constructive stock dividend[128] which is allocable ratably over the years during which the stock is not redeemable, and section 305(b) (4) causes the constructive stock dividend to be taxable under section 301.[129] Moreover, if the corporation distributes a stock dividend to the class *A* shareholders, the distribution will be taxable because the class *B* shareholders have received property by virtue of the taxable constructive stock dividend and the class *A* shareholders have received an increase in their proportionate interests due to the dilution of the class *B* conversion privilege.[130]

Section 305(c) also generally refers to a redemption which is treated as a distribution to which section 301 applies.[131] This provision is designed to create, for example, a constructive stock dividend to nonredeeming common shareholders or redeeming common shareholders who have redeemed fewer shares than other common shareholders when a corporation periodically redeems outstanding common stock.[132] The proposed

125. *Id.* § 305(b)(2)(A). There is uncertainty whether the distribution of property contemplated by section 305(b)(2)(A) must be an actual distribution of property or whether a constructive distribution of property will suffice. The proposed regulations indicate that the latter is within the context of section 305(b) (2)(A). Proposed Treas. Reg. § 1.305-3(e) Ex. (13), 36 Fed. Reg. 5224 (1971).
126. I.R.C. § 305(b)(2).
127. *See* Proposed Treas. Reg. §§ 1.305-5(b), -5(c) Exs. (7), (8), 36 Fed. Reg. 5225-26 (1971).
128. *See id.* § 1.305-5(b)(1), 36 Fed. Reg. 5225 (1971); *id.* § 1.305-7, 37 Fed. Reg. 4966 (1972).
129. See text accompanying notes 194-201 *infra.*
130. Proposed Treas. Reg. § 1.305-3(e) Ex. (13), 36 Fed. Reg. 5224 (1971).
131. Whether section 301 applies to a redemption is determined under section 302. *See generally* BITTKER & EUSTICE ¶ 9.20-.30, at 36.
132. The theory underlying this treatment is that the non-redeeming shareholders receive an increase in their proportionate interests while the redeeming shareholders receive cash, a result which is equivalent to the payment of a stock dividend to some shareholders and a cash dividend to other shareholders.

regulations take the position that the requisites of section 305(b) (2) are met when some shareholders receive cash when they redeem and nonredeeming shareholders receive a corresponding automatic increase in their proportionate interest because of the redemption.[133] The amount of the constructive stock dividend to nonredeeming shareholders to which section 301 applies is determined by a three-step process: (1) the percentage increase in the shareholder's proportionate interest is determined; (2) the number of shares required to effect such a change is determined; and (3) the fair market value of such shares is ascertained.[134]

The result is unclear, however, if section 301 does *not* apply to the redemption because section 302(b) is satisfied.[135] For example, assume that *X* Corporation has only 200 shares of common stock outstanding which are held equally by two unrelated individual shareholders, *A* and *B*. *A* assigns to *X* Corporation an option to purchase one-half of the *X* Corporation shares held by *B*. *X* Corporation then redeems these 50 shares from *B* for $50,000 cash (*B*'s basis for these 50 shares is $25,000) at a time when it has sufficient earnings and profits to more than cover the amount of the redemption distribution. On these facts it is clear that *B* will have $25,000 gain in "exchange" for his 50 shares because as to him the distribution was substantially disproportionate.[136] What is the effect, if any, as to *A*?

Under the law prior to the T.R.A. it was fairly well settled that in this situation the redemption of the stock from *B* did not trigger a constructive dividend to *A* even though its effect was to increase *A*'s interest in *X* Corporation from 50 percent to 66⅔ percent.[137] Section 305(b)(2) now casts some doubt on the continuing vitality of this conclusion, however, because, as the result of the redemption distribution, property[138] has been received by shareholder *B*,[139] and shareholder *A* has increased his proportionate interest in the assets or earnings and profits of *X* Corporation.[140] Because section 305(b) (2) (A) is not limited in application to section 301 distributions of property,[141] *A* might be deemed to have received a taxable constructive stock dividend distribution.[142]

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133. Proposed Treas. Reg. § 1.305-3(e) Ex. (8), 36 Fed. Reg. 5223-24 (1971). *Contra*, BITTKER & EUSTICE ¶ 7.62, at 74; Eustice, *supra* note 2, at 546-47.
134. For an illustration of this process, see Proposed Treas. Reg. § 1.305-3(e) Ex. (8), (9), 36 Fed. Reg. 5223-24 (1971). For a criticism of the method utilized by the proposed regulation see Tierney, *supra* note 111, at 187-88.
135. *See* I.R.C. § 302(a) & (d).
136. *Id.* § 302(a) & (b)(2).
137. *See, e.g.*, Holsey v. Commissioner, 258 F.2d 865 (3d Cir. 1958); Rev. Rul. 69-608, 1969-2 CUM. BULL. 42.
138. The $50,000 cash constitutes "property" within the meaning of section 305(b)(2)(A). I.R.C. § 317(a).
139. *Id.* § 305(b)(2)(A).
140. *Id.* § 305(b)(2)(B).
141. Eustice, *supra* note 2, at 546. *Contra*, Metzer, *supra* note 36, at 112, 116.
142. *See* Metzer, *supra* note 36, at 115. *Contra*, Eustice, *supra* note 2, at 546-47.

Insofar as it is applicable here, section 305(c) specifically provides that

> the Secretary or his delegate shall prescribe regulations under which . . . a redemption which is treated as a distribution to which section 301 applies . . . shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such . . . redemption. . . .

In its report on this provision the Senate Finance Committee stated that "the committee does not intend that this regulatory authority is to be used to bring isolated redemptions of stock under the disproportionate distribution rule (of sec. 305(b) (2))."[143] Although the foregoing makes it clear that the section 305(c) regulatory authority is not intended to encompass isolated redemptions,[144] it does not strictly mean that section 305(b) (2) in and of itself does not apply to them. In addition, it is apparent that the above transaction does not technically come within section 305(c) (and, hence, is not protected as an isolated redemption) because, as to *B*, the redemption was substantially disproportionate under section 302(b) (2) and consequently is not governed by section 301.[145]

Although the legislative history referred to is persuasive evidence of the congressional intent not to create a taxable stock dividend as to *A* in this situation, there appears to be a better reason why the above transaction should not come within the meaning of section 305(b) (2) considered alone.[146] Analysis indicates that the redemption of *B*'s stock for cash is serving a dual purpose—it is both the property distribution of section 305(b)(2)(A) and it results in the increase in proportionate interest of section 305(b)(2)(B). Yet the term "distribution" in section 305(b)(2) to which both purposes relate is obviously in reference to the use of that term in sections 305(a) and 305(b) which require that it be a distribution of stock. Given that the *constructive* stock distribution rule of section 305(c) is not applicable,[147] it would seem that for section 305(b) (2) to apply in this situation there must be an *actual* stock distribution—and there is no such actual distribution here. Accordingly, there should be no taxable stock dividend to *A* on these facts.[148]

Finally, the section apparently does not apply to a redemption in anticipation of the retirement of some of a corporation's shareholder-em-

143. S. REP. No. 91-552, at 153. The report states as an example that "a 30 percent stockholder would not be treated as receiving a constructive dividend because a 70 percent stockholder causes a corporation to redeem 15 percent of its stock from him." *Id.* at 153-54.

144. Proposed Treas. Reg. § 1.305-3(e) Ex. (10), 36 Fed. Reg. 5224 (1971).

145. I.R.C. § 302(a) & (d).

146. The proposed regulations are non-committal, however, dealing only with an isolated redemption which is governed by section 301. Proposed Treas. Reg. § 1.305-3(e) Ex. (10), 36 Fed. Reg. 5224 (1971).

147. See text accompanying note 145 *supra.*

148. *See* BITTKER & EUSTICE ¶ 7.62, at 74; Eustice, *supra* note 2, at 546-47. *See also* Metzer, *supra* note 36, at 114-16.

ployees since such a redemption is not made pursuant to a plan for periodically redeeming the stock of the corporation.[149] Hopefully, this section has been limited to periodic redemptions which are designed to provide cash to some shareholders and an increase in the proportionate interest of other shareholders. It seems certain that many redemptions fall between the periodic-isolated dichotomy and prediction of tax consequences in such situations will be difficult.[150]

Predictability is likely to be even more difficult with regard to the final category of transactions prescribed in section 305(c). This category covers "any transaction . . . having a similar effect on the interest of any shareholder."[151] Although the ultimate scope of this category will be determined by administrative and judicial interpretation, an analysis of its potential application is necessary to facilitate adequate tax planning during the interim.

Initially, it should be observed that the statute specifically provides that recapitalizations are included.[152] This fact gives some indication of the breadth of the language. Conversely, the concluding language of the provision shows that the transactions included must be similar in effect to a change in conversion ratio or redemption price, a difference between redemption price and issue price, or a redemption.[153] The only insight gleaned from the proposed regulations relates to the purposes of the recapitalizations covered. Within the realm of section 305(b) (2), the proposed regulations indicate that in the context of a single and isolated transaction, a recapitalization utilized for the purpose of allowing retiring shareholders to convert their common stock to preferred stock is not one to which section 301 applies.[154] This is consistent with the exemption of isolated redemptions from the operation of the section.

A further question is whether this broad language has application in a type "A" reorganization[155] wherein some shareholders receive cash and others receive stock. The American Bar Association Tax Section in its report on the T.R.A. indicated the potential for dividend taxation in such a situation.[156] For example, assume that *A* Corporation acquires *B* Corporation in a consolidation or merger pursuant to Arizona law[157] and some

149. Proposed Treas. Reg. § 1.305-3(e) Ex. (11), 36 Fed. Reg. 5224 (1971).
150. *See* Metzer, *supra* note 36, at 114-17.
151. I.R.C. § 305(c).
152. *Id.*
153. *Id.*
154. Proposed Treas. Reg. § 1.305-3(e) Ex. (12), 36 Fed. Reg. 5224 (1971). For a thorough treatment of the application of section 305 within the recapitalization context, see Levin, *The Effect of the Tax Reform Act of 1969 on Recapitalizations, Redemptions, and the Public Policy Doctrine*, U. So. CAL. 1971 TAX INST. 293, 294-305 (1971).
155. I.R.C. § 368(a)(1)(A) defines this type of reorganization as "a statutory merger or consolidation."
156. *Report on H.R. 13270, Tax Reform Act of 1969*, 23 TAX LAW. 43, 107 (1969). *See also* Sirowitz, *The 1969 Reformation of Stock Dividend Rules*, 1 TAX ADV. 360 (1970).
157. ARIZ. REV. STAT. ANN. §§ 10-341 *et seq.* (1956).

dissenting shareholders elect to receive cash for their shares as allowed by an Arizona statute.[158] The continuing shareholders thereby necessarily increase their proportionate interest in the earnings and profits of the combined corporation. If the Commissioner attempts to assert that such a receipt of cash with the concomitant increase in proportionate interests results in a taxable stock dividend, the taxpayers could logically argue that the acquisition stock was not distributed with respect to the acquiring corporation's stock.[159] Alternatively, taxpayers might argue that such a transaction is analogous to isolated redemptions which have been exempted from the operation of section 305, and that the rationale underlying the isolated redemption exemption[160] is equally applicable in the acquisitive reorganization context. Further, since section 305(c) refers specifically to recapitalizations rather than reorganizations, there is some weight to an argument that this indicates congressional intent to exclude reorganizations other than recapitalizations.[161] On the other hand, since the reorganization provisions are aimed at facilitating readjustments of continuing interests in modified corporate forms,[162] this may be an incentive to impose the taxable stock dividend treatment when reorganizations have the effect of increasing the proportionate interests of the continuing shareholders. While it seems likely that taxpayers would prevail in the face of such an attack by the Commissioner,[163] such a result is uncertain. Section 305(b) (2), particularly in combination with section 305(c), is broad in scope and, unfortunately, its possible application in many situations is extremely vague and uncertain. Absent clarification by the final regulations, it deserves cautious respect from attorneys planning business transactions.

Distributions of Common and Preferred Stock: Section 305(b) (3)

Section 305(b)(3) provides that the stock dividend distribution will be taxable "[i]f the distribution (or a series of distributions of which such distribution is one) has the result of (A) the receipt of preferred stock by some common shareholders, and (B) the receipt of common stock by other common shareholders." Generally, when such distributions occur the proportionate interests of all of the stock dividend recipients in the assets or earnings and profits of the corporation are increased.[164] Hence, it can be regarded as designed to reach devices to which section 305(b) (2) does not apply because of the absence of a property distribution.[165]

158. *Id.* § 10-347.
159. *See* 94 BNA TAX MANAGEMENT PORTFOLIO: STOCK DIVIDENDS AND STOCK RIGHTS at A-24 (3d ed. 1970).
160. See text accompanying notes 135-49 *supra*.
161. A recapitalization is a subdivision within the Code defintion of reorganizations. I.R.C. § 368(a)(1)(E).
162. Treas. Reg. §§ 1.368-1(b), -2(g) (1955).
163. 94 BNA TAX MANAGEMENT PORTFOLIO, *supra* note 159 at A-24.
164. *See* Metzer, *supra* note 36, at 129-30.
165. *See* I.R.C. §§ 305(b)(2)(A), 317(a). The legislative history shows that

In other words, it was intended at the very least to prevent the avoidance of the disproportionate distribution exception of 305(b)(2) in the context of the "two-classes-of-common-stock" plan by the distribution of preferred stock instead of cash.[166] Although it is directed at a transaction which normally causes an increase in proportionate interests, technically the section does not require such an increase. The operation of this exception is illustrated by the following example. *X* Corporation which has two classes of common stock, *A* and *B*, distributes a dividend of class *A* stock to class *A* shareholders and a dividend of a newly authorized class *C* preferred stock to class *B* shareholders. Both distributions are ones to which section 301 applies.[167]

A timing problem similar to the one discussed under section 305(b)(2)[168] could occur under this exception since the exception applies if a series of distributions has the requisite effect. For example, if the result is caused by separate distributions occurring in two different taxable years, the shareholder receiving the earlier distribution may be unable to determine the tax status of the stock dividend until after the time he is required to file his federal income tax return. Again, the resolution of this problem must await clarification from the Commissioner.

Interestingly, where a corporation with only one class of stock outstanding, class *A* common, distributes a stock dividend thereon consisting of newly-authorized class *B* preferred, which is convertible into class *A* common, the exception may apply even where there is, in fact, no future increase in proportionate interests as a result of the distribution. This could happen where all the shareholders actually convert or none convert[169] simply because at the time of distribution there was a likelihood that some would convert and some would not.[170] As to whether in any

this specific exception first appeared in the Senate version of the T.R.A. in order to "carry out more explicitly the intention of the House with regard to distributions of common and preferred stock on common stock." S. REP. No. 91-552, at 152. The House bill had originally provided that, in connection with the exception now constituting sections 305(b)(1) & (2), "section 306 stock shall be treated as property which is not stock." H.R. 13270, 91st Cong., 1st Sess. § 421(a) (1969). The effect of the House provision would have been to treat the preferred stock as property, just as if it were cash.

166. See H.R. REP. No. 91-413, at 113; BITTKER & EUSTICE ¶ 7.62, at 77.

167. For other examples of the operation of this exception, see Proposed Treas. Reg. § 1.305-4(b), 36 Fed. Reg. 5224 (1971).

168. See text following note 104 *supra*.

169. See Strassburger v. Commissioner, 318 U.S. 604 (1943); Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954).

170. Proposed Treas. Reg. § 1.305-4(b) Ex. (2), 36 Fed. Reg. 5225 (1971). Account should also be taken of new section 305(b)(5) which makes distributions of convertible preferred stock taxable "unless it is established to the satisfaction of the Secretary or his delegate that such distribution will not have the result described in [section 305(b)(2)]." Since it is clear that section 305(b)(2) requires that there also be a distribution of "property," the proposed regulation indicates that section 305(b)(3) will be utilized by the Commissioner to "backstop" section 305(b)(5) on distributions of convertible preferred which are unaccompanied by the requisite property distribution. Tierney, *supra* note 96, at 88-89 & n.4.

particular case there is such a likelihood, the proposed regulation suggests that a six-month conversion period may result in taxability, stating:

> Taking into account the dividend rate, redemption provisions, the marketability of the convertible stock, and the conversion price, it is reasonable to anticipate that within a relatively short period of time some shareholders will exercise their conversion rights and some will not. Since the distribution can reasonably be expected to result in the receipt of preferred stock by some common shareholders and the receipt of common stock by other common shareholders, the distribution is a distribution of property to which section 301 applies.[171]

This standard appears to make taxability almost inevitable since any time a corporation issues a convertible preferred stock there is a likelihood that some shareholders will convert while others will not.[172] At any rate, it appears that the likelihood of the failure to convert only one share would be enough to transform the entire distribution into one to which section 301 applies.[173] Mitigation of this harsh result is suggested by the proposed regulation under section 305(b) (5) where it is stated that a conversion period of 20 years would normally preclude a prediction that some shareholders would convert and that others would not.[174] On the other hand, a 4 month conversion period will be a strong indicium that some shareholders will convert and that others will not.[175] There is no guidance, however, for situations falling between such extremes.

Curiously absent from the proposed regulations under this exception is a melding of potential section 305(c) applications.[176] The most obvious situation in which some common shareholders receive preferred stock and others receive common stock is a recapitalization pursuant to section 368(a)(1)(E). Although the proposed regulations under section 305 (b)(2) indicate that a recapitalization designed to facilitate the retirement of certain shareholders is not to be considered a distribution to which section 301 applies,[177] it should not be assumed that this is a broad grant of recapitalization freedom,[178] particularly in view of the emphasis

171. Proposed Treas. Reg. § 1.305-4(b) Ex. (2), 36 Fed. Reg. 5225 (1971).

172. A more realistic test of taxability might be the "concerted plan" standard applied by the Commissioner with respect to the section 306 stock status of convertible preferred stock received in reorganizations. *See* Rev. Proc. 66-34, 1966-2 Cum. Bull. 1232.

173. The Senate Finance Committee proposed a de minimis rule which would relieve insignificant increases from taxable status. S. Rep. No. 91-552, at 154. This rule was deleted by the Conference Committee, however. H.R. Rep. No. 91-782, 91st Cong., 1st Sess. 309-10 (1969).

174. Proposed Treas. Reg. § 1.305-6(b) Ex. (1), 36 Fed. Reg. 5226 (1971). This rule had its genesis in the Senate Finance Committee. S. Rep. No. 91-552, at 153.

175. Proposed Treas. Reg. § 1.305-6(b) Ex. (2), 36 Fed. Reg. 5226 (1971). This guideline was suggested by the Senate Finance Committee. S. Rep. No. 91-552, at 152-53.

176. Proposed Treas. Reg. § 1.305-4(b), 36 Fed. Reg. 5224-25 (1971).

177. *Id.* § 1.305-3(e) Ex. (12), 36 Fed. Reg. 5224 (1971).

178. *See* Levin, *supra* note 154.

in the proposed regulation on the recapitalization occurring in the context of "a single and isolated transaction."[179] The reasons favoring exemption of such recapitalizations from the operation of section 305 are presumably similar to those underlying the exemption of isolated redemptions.[180]

Distributions on Preferred Stock: Section 305(b) (4)

Section 305(b) (4), which is a vastly expanded version of old section 305(b) (1),[181] provides that a stock dividend distribution will be taxable "[i]f the distribution is [made] with respect to preferred stock, other than an increase in the conversion ratio of convertible preferred stock made solely to take account of a stock dividend or stock split with respect to the stock into which such convertible stock is convertible."[182]

179. Proposed Treas. Reg. § 1.305-3(e) Ex. (12), 36 Fed. Reg. 5224 (1971).

180. *See* BITTKER & EUSTICE ¶ 7.62, at 75, 76 n.130. There is also uncertainty whether a section 368(a)(1)(A) reorganization might possibly run afoul of this exception. The issue may arise since such acquisitive reorganizations are often consummated by paying for the common stock of an acquired corporation with preferred stock because such stock has desirable characteristics for both the acquiring and acquired parties. The acquiring corporation often favors the use of preferred stock since it does not dilute the equity interest of its shareholders. Further, acquired corporation shareholders frequently desire preferred stock since it provides them with more security, particularly if it is convertible preferred. It is doubtful, however, that section 305 would apply at all because the stock of the acquiring corporation would constitute part of the purchase price of the acquired corporation and, hence, could not be said to be distributed by the acquiring corporation "with respect to its stock" as required by section 305. See text accompanying notes 155-63 *supra.* Moreover, recent changes in accounting for business combinations forbid pooling of interest treatment when the consideration given is other than common stock. This change is likely to decrease the use of preferred stock in acquisitions. For a discussion of the recent accounting changes, see Note, *AICPA Efforts to Curb Abuses in Accounting for Corporate Acquisitions: Their Inadequacies and a Proposed Solution,* 12 ARIZ. L. REV. 543 (1970).

181. Section 305(b)(1) prior to the T.R.A. had provided that the stock dividend distribution would be taxable "to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year."

182. Proposed Treas. Reg. § 1.305-5(a), 37 Fed. Reg. 4965 (1972):

> The term "preferred stock" means stock which, in relation to other classes of stock outstanding, enjoys certain limited rights and privileges (generally associated with specified dividend and liquidation priorities) but does not participate in corporate growth to any significant extent. Generally, the distinguishing feature of "preferred stock" for the purposes of section 305(b)(4) is not its privileged position as such, but that such privileged position is limited, and that such stock does not participate in corporate growth to any significant extent. However, a right to participate which lacks substance will not prevent a class of stock from being treated as preferred stock. Thus, stock which enjoys a priority as to dividends and on liquidation but which is entitled to participate, over and above such priority, with another less privileged class of stock in earnings and profits and upon liquidation, may nevertheless be treated as preferred stock for purposes of section 305 if, taking into account all the facts and circumstances, it is reasonable to anticipate at the time a distribution is made (or is deemed to have been made) with respect to such stock that there is little or no likelihood of such stock actually participating in current and anticipated earnings and upon liquidation beyond its preferred interest. Among the facts and circumstances to be considered are the prior and anticipated earnings per share, the cash dividends per share, the book

Accordingly, section 305(b)(4) limits the tax-free treatment of stock dividends available under section 305(a) to distributions with respect to common stock only.[183]

In its simplest form, the exception operates as follows. A corporation with a class of preferred stock outstanding distributes a stock dividend of one share of preferred for each share of preferred stock outstanding. Under section 305(b)(4), the distribution of the additional preferred is one to which section 301 applies,[184] and the amount of the dividend presumably equals the fair market value of the stock distributed.[185] A similar result obtains if the dividend is paid in common stock. A further application of this section occurs when stock is distributed with respect to preferred stock in discharge of preference dividends.[186] This is a continuation of the rule embodied in old section 305(b) (1) although the old rule was limited to discharges of preferred dividends for the current and preceding taxable years.[187]

This exception does not apply, however, to an increase in the conversion ratio of convertible preferred stock made solely to reflect a stock split or stock dividend with respect to the stock into which such convertible stock may be converted.[188] Because most convertible preferred stock is protected by an antidilution clause, this exemption is essential. A comparison of the typical antidilution clause to the scope of the exemption granted is necessary to determine the safe limits of such clauses in the future.

To prevent the dilution of the conversion privilege, typical events upon which adjustment is required are:

> (a) issuance of shares for less than the conversion price, (b) issuance of rights to subscribe to or purchase shares or securities convertible into shares, (c) issuance of securities convertible into or exchangeable for shares, at a price less than the conversion price, (d) issuance of dividend of shares or securities convertible into shares, (e) share splits, (f) abnormally large cash dividends, (g) distributions of assets, (h) subdivision or combination of shares or securities convertible into shares; and

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value per share, the extent of preference and of participation of each class, both absolutely and relative to each other, and any other facts which indicate whether or not the stock has a real and meaningful probability of actually participating in the earnings and growth of the corporation. The term "preferred stock" includes nonparticipating stock the terms of which require in all events, periodic distributions with respect to it of stock or rights to acquire stock, provided the corporation has another class of stock outstanding. The term "preferred stock", however, does not include convertible debentures.

Cf. Treas. Reg. § 1.305-3(b)(1) (1969).

183. *See* H.R. REP. No. 91-413, at 114; S. REP. No. 91-552, at 152.

184. *See* Proposed Treas. Reg. § 1.305-5(c) Ex. (1), 36 Fed. Reg. 5225 (1971).

185. Treas. Reg. § 1.305-2(c)(1) (1960).

186. *See* Proposed Treas. Reg. § 1.305-5(c) Ex. (3), 36 Fed. Reg. 5225 (1971). See text accompanying notes 204-10 *infra*.

187. See note 181 *supra*.

188. I.R.C. § 305(b)(4).

(i) reorganizations, reclassifications, mergers, or consolidations.[189]

Contrasting these typical contingencies, which frequently trigger an adjustment of the conversion ratio, with the narrow exemption granted by section 305(b) (4) for stock dividends and stock splits, indicates potential problems with using traditional "boilerplate" antidilution clauses. The acuity of future problems is mitigated to some extent by a broadening of the exemption suggested by the proposed regulation which adds the phrase "or any similar adjustment . . . which would otherwise result in the dilution of the conversion right."[190] An example given by the proposed regulations of a similar adjustment is "the sale of stock of the distributing corporation to employees at less than the fair market value."[191] The status of a provision allowing for the future adjustment in the conversion ratio to reflect future earnings which is used as a substitute for a contingent stock earn-out provision in an acquisitive reorganization is uncertain.[192] Generally, it appears that traditional antidilution clauses will incur the risk of causing a taxable stock dividend. Moreover, assuming the presence of a corresponding property distribution, it should be remembered that a clause to protect against dilution of the conversion privilege is essential to prevent taxation under section 305(b) (2) of common stock distributions with respect to the common stock into which the preferred is convertible.[193]

Section 305(c) has extensive application within the purview of this exception. Increases in conversion ratios, excessive redemption premiums and recapitalizations are likely to be the most frequent section 305(c) events which are covered by section 305(b) (4). Increases in conversion ratios on preferred stock which are not within the exemption granted to prevent dilution will be treated as constructive stock distributions to which section 301 applies.[194] To illustrate, a corporation has two classes of stock outstanding, *A* and *B*, and the class *B* stock may be converted into class *A* at any time. Assume further that the conversion ratio is increased annually by one-tenth share of class *A* stock.[195] This increase is treated as a section 301 distribution and the amount of the distribution per preferred share equals the fair market value of one-tenth share of class *A* stock.[196]

189. H. HENN, *supra* note 6, at 288-89 (footnote omitted).
190. Proposed Treas. Reg. § 1.305-5(a), 37 Fed. Reg. 4965 (1972).
191. *Id.*
192. See text accompanying notes 63-65 *supra.*
193. See text & notes 98-100 *supra.*
194. I.R.C. § 305(c). For a discussion of allowable anti-dilution clauses, see text accompanying notes 189-93 *supra.*
195. The annual increase in the conversion ratio causes the class *B* stock to be viewed as preferred stock within the meaning of section 305(b)(4). Proposed Treas. Reg. § 1.305-5(a), -7(a), 37 Fed. Reg. 4965-66 (1972).
196. *See* Proposed Treas. Reg. § 1.305-5(c) Ex. (2), 36 Fed. Reg. 5225 (1971).

A redemption premium on preferred stock may result in constructive distributions, to which section 301 applies, which are amortized over the period of time during which the stock is not redeemable.[197] The proposed regulations offer an exemption from taxation if the premium is a reasonable one and is not a substitute for dividends.[198] They further state that a redemption premium not in excess of 10 percent of the issue price on stock which is not redeemable for five years from the date of issue shall be considered reasonable.[199] It appears likely that a similar provision will be included in the final regulations.[200]

The following example will serve to illustrate the redemption premium application. A class of preferred stock was issued for $50 per share and is redeemable in five years for $100. Taking into consideration the 10 percent reasonable redemption premium exemption, the excessive premium is $45 per share. If there are no facts to indicate that this is a reasonable redemption premium, sections 305(b) (4) and 305(c) require that this premium be amortized over the five year period during which redemption is prohibited. Accordingly, preferred shareholders will be deemed to receive a $9 per share section 301 distribution each year.[201]

A situation may exist in which preferred stock is both convertible and redeemable. Further, there may be provisions allowing increases in the conversion ratio and an excessive redemption premium. In such instances, a distribution to which section 301 applies will be deemed to be made with respect to such stock equal to the greater of the distribution arising because of the increased conversion ratio, or the distribution deemed to be made because of the excessive redemption premium.[202] This result is proper since the shareholder is limited to the benefit of one or the other by the fact that he must either convert his stock or let it be redeemed.

Because recapitalizations often effect changes in preferred stockholdings, it is necessary to consider the impact of section 305(b) (4) upon such capital structure realignments.[203] The reorganization regulations dealing with recapitalization provide:

> A 'recapitalization,' and therefore a reorganization takes place if . . . [a]n exchange is made of an amount of a corporation's outstanding preferred stock with dividends in arrears

197. I.R.C. § 305(c); Proposed Treas. Reg. § 1.305-5(c) Ex. (8), 36 Fed. Reg. 5226 (1971).
198. Proposed Treas. Reg. § 1.305-5(b)(2), 36 Fed. Reg. 5225 (1971).
199. *Id.*
200. The legislative history surrounding the T.R.A. changes clearly indicates that such a reasonableness standard should apply. H.R. REP. No. 91-413, at 115; S. REP. No. 91-552, at 154.
201. For further illustrations, see Proposed Treas. Reg. § 1.305-5(c) Exs. (7), (8), 36 Fed. Reg. 5225-26 (1971).
202. *Id.* § 1.305-5(c) Ex. (9), 36 Fed. Reg. 5226 (1971).
203. *See generally* Levin, *supra* note 154.

> for a similar amount of a corporation's preferred stock plus an amount of stock (preferred or common) with respect to the amount of dividends in arrears. However, if such an exchange is made solely for the purpose of effecting the payment of dividends for the current and immediately preceding taxable years upon the preferred stock exchanged, an amount equal to the value of the stock issued in lieu of such dividends shall be treated as a distribution to which section 305(b)(1) is applicable.[204]

The reference in the foregoing regulation to section 305(b) (1) is to that section as it existed prior to the T.R.A. and which made a stock dividend distribution taxable to the extent it was in discharge of preferred dividends for the current and preceding taxable year. It is clear that section 305(b) (4) now encompasses recapitalizations designed to distribute additional preferred stock in discharge of all (not merely those for the current and preceding taxable years) preference dividends so that section 301 will apply.[205] It is disturbing, however, to discover that, despite the fact that the additional preferred stock dividend distribution is taxable under section 305(b) (4),[206] such additional preferred stock will technically still be section 306 stock.[207] The example given in the proposed regulation involves a recapitalization in which the old preferred stock, as to which the corporation is 3 years in arrears on its dividends, is exchanged for new preferred stock in an amount equal to the value of the old preferred plus the value of the dividend arrearages.[208] Section 306 stock is defined by the statute to include

> stock which is not common stock and which was received . . . in pursuance of a plan of reorganization (within the meaning of section 368(a)) . . . and . . . with respect to the receipt

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204. Treas. Reg. § 1.368-2(e)(5) (1955).

205. Proposed Treas. Reg. § 1.305-5(c) Ex. (3), 36 Fed. Reg. 5225 (1971). *See* Bittker & Eustice ¶ 7.62, at 76 n.130, 77; *id.* ¶ 14.17, at 61; Del Cotto & Wolf, *supra* note 36, at 64-65; Metzer, *supra* note 36, at 135-36; *Report on H.R. 13270, supra* note 156, at 108-09. In this regard the Senate Finance Committee report stated:

> It is anticipated that the regulations will provide that if preferred stockholders are given stock in a recapitalization, or an increase in proportionate interest by means of a constructive distribution, as payment of current dividends or dividend arrearages, sec. 305(b)(4) is to apply whether or not the recapitalization or other transaction is an isolated transaction. Thus, if in a recapitalization preferred stockholders are given additional preferred stock in satisfaction of several years dividend arrearages, the distribution of the additional stock will be taxable (under sec. 301).

S. Rep. No. 91-552, at 154. For a situation in which a recapitalization may operate to discharge preference dividend arrearages but section 305(b) may not apply, see Proposed Treas. Reg. § 1.305-5(c) Ex. (4), 36 Fed. Reg. 5225 (1971).

206. I.R.C. § 306(c)(1)(A).

207. *Id.* § 306(c)(1)(B). *See* Metzer, *supra* note 36, at 136. On the subsequent sale of section 306 stock there will be ordinary gain. I.R.C. § 306(a)(1)(A). If the section 306 stock is subsequently redeemed, instead of sold, it is subject to dividend treatment under section 301. *Id.* § 306(a)(2). For the definition of "redemption of stock," see *id.* § 317(b).

208. Proposed Treas. Reg. § 1.305-5(c) Ex. (3), 36 Fed. Reg. 5225 (1971).

> of which gain or loss to the shareholder was *to any extent* not recognized by reason of part III, but only to the extent that . . . the effect of the transaction was substantially the same as the receipt of a stock dividend . . . .[209] [Emphasis added.]

On the facts given, because the preferred stock was received in a recapitalization reorganization under section 368(a)(1)(E), the shareholder did not recognize gain or loss thereon by virtue of section 354(a)(1), and the receipt of the stock was treated as a stock dividend (albeit taxable) under section 305(b)(4). It appears that in these circumstances the definitional elements have been satisfied so as to classify the stock as section 306 stock. Although this is the result of legislative oversight and may have to be remedied by Congress,[210] the taxpayer caught in the toils of this technicality may resort to section 306(b) (4). Under that section the Commissioner could probably be persuaded to issue a favorable ruling that section 306(a) would not apply to the subsequent disposition of such stock since the penalty of dividend treatment had already been paid by the taxpayer on its receipt under sections 305(b) (4) and 301.[211]

Distributions of Convertible Preferred Stock: Section 305(b) (5)

Distributions of convertible preferred stock are treated as section 301 distributions unless it is established that such distributions will not result in the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.[212] The legislative history surrounding this exception indicates that the length of the conversion period will be a significant factor in determining whether the distribution will be one to which section 301 applies.[213]

The proposed regulations state that the distribution is likely to result in a disproportionate distribution when both of the following conditions exist:

> (i) [T]he conversion right must be exercised within a relatively short period of time after the date of distribution of the stock; and (ii) taking into account such factors as the dividend rate, the redemption provisions, the marketability of the convertible stock, and the conversion price, it may be anticipated that some shareholders will exercise their conversion rights and some will not. On the other hand, where the conversion right may be exercised over a period of many years and the dividend rate is consistent with market conditions at the time of distribution of the stock, there is no basis for predicting at what time and the

209. I.R.C. § 306(c)(1)(B).
210. Metzer, *supra* note 36, at 136.
211. *See* I.R.C. § 306(c)(1)(A).
212. *Id.* § 305(b)(5). *See generally* Metzer, *supra* note 36, at 136-38. Thus, a distribution of convertible preferred unaccompanied by a property distribution is not governed by section 305(b)(5). See note 170 *supra*.
213. H.R. REP. No. 91-413, at 113-14; S. REP. No. 91-552, at 152-53.

extent to which the stock will be converted and it is unlikely that a disproportionate distribution will result.[214]

Section 305(b) (5) applies only to distributions of convertible preferred with respect to common stock since section 305(b) (4) covers such distributions with respect to preferred stock.[215] Assume that a corporation with one class of common stock outstanding distributes a convertible preferred stock dividend with respect to such stock. If the stock is convertible for a period of 20 years and the dividend rates are normal, the proposed regulations take the position that the exception does not apply.[216] On the other hand, if the same stock were convertible for only 4 months from the date of distribution, the proposed regulations state that the exception applies,[217] while a conversion period of 6 months is likely to activate the exception.[218] No guidelines are available for analyzing conversion periods between these extremes. This exception, in addition to incorporating many of the problems of section 305(b) (2) by adopting that section's disproportionate distribution rule, lacks objective standards by which to gauge when a distribution of convertible preferred stock will have a disproportionate effect.

Stock Rights and Convertible Securities: Section 305(d)

For purposes of section 305 the term "stock" is defined as including rights to acquire the corporation's stock,[219] and the term "shareholder" as encompassing holders of rights or convertible securities.[220] At this point it becomes appropriate to consider the significance of these definitions.

Stock Rights

Although the classification of rights as stock did not begin with the T.R.A., several aspects pertaining to stock rights are worthy of consideration.[221] Initially, the distribution of stock rights by a corporation with respect to its stock is nontaxable unless one of the exceptions of section 305(b) applies in which case the foregoing discussion of stock dividends is applicable.[222] The basis rules applying to nontaxable stock rights, however, are somewhat different from those covering other nontaxable stock dividends.

214. Proposed Treas. Reg. § 1.305-6(a)(2), 36 Fed. Reg. 5226 (1971).
215. See discussion of section 305(b)(4) in text following note 180 *supra*.
216. Proposed Treas. Reg. § 1.305-6(b) Ex. (1), 36 Fed. Reg. 5226 (1971).
217. *Id.* § 1.305-6(b) Ex. (2), 36 Fed. Reg. 5226 (1971).
218. *Id.* § 1.305-4(b) Ex. (2), 36 Fed. Reg. 5225 (1971).
219. I.R.C. § 305(d)(1).
220. *Id.* § 305(d)(2).
221. For a general discussion of the meaning of "stock rights," see 94 BNA Tax Management Portfolio, *supra* note 159, at A-54 to -55.
222. This is due to the fact that the term "stock" in section 305 includes stock rights. I.R.C. § 305(d)(1).

Where nontaxable stock rights are distributed, the shareholder is required to allocate a portion of the basis of the old stock to the rights when the rights are exercised or sold,[223] unless at the time of distribution the fair market value of the rights is less than 15 percent of the fair market value of the old stock.[224] In the latter case, section 307(b) specifies that the basis of the rights shall be zero unless the shareholder elects to make the basis allocation as prescribed by section 307(a).[225] The process of allocating basis to nontaxable stock rights is illustrated by the following example. Assume that the shareholder has 100 shares of stock with an aggregate cost basis of $5,000 and receives rights to purchase, at $50, one share for each share owned. The fair market value (FMV) of the old stock at the date of distribution is $56 per share and the rights have a fair market value at such time of $4 each. The allocation of basis under section 307(a) would be computed as follows:

BASIS ALLOCATED TO RIGHTS

$$\frac{\text{FMV Rights}}{\text{FMV Old Stock} + \text{Rights}} \times \text{Adjusted Basis} = \text{Basis of Rights}$$

$$\frac{\$\ 400}{\$6{,}000} \times \$5{,}000 = \$333$$

BASIS ALLOCATED TO OLD STOCK

$$\frac{\text{FMV Old Stock}}{\text{FMV Old Stock} + \text{Rights}} \times \text{Adjusted Basis} = \text{Basis of Old Stock}$$

$$\frac{\$5{,}600}{\$6{,}000} \times \$5{,}000 = \$4{,}667$$

It should be noted, however, that in this situation the exception of section 307(b) applies. Under section 307(b) the basis of the old stock will remain at $5,000 and the rights will have a basis of zero. Nevertheless, the shareholder may elect to allocate basis pursuant to section 307(a) as computed above. In either event, section 1223(5) permits a "tacking" of the holding period of the underlying shares in determining the holding period of the rights.[226]

If section 305(a) does not apply to the distribution of stock rights, the distribution will be treated as one to which section 301 applies.[227] The general tax consequences attached to taxable stock rights are as follows: (1) the shareholder receives a taxable dividend at the time the

223. Treas. Reg. § 1.307-1(a) (1955) (last sentence).
224. I.R.C. § 307(a) & (b). Where the stock rights are distributed with respect to various lots of stock held by a shareholder and an allocation is made, it will be necessary to allocate the particular rights to the lots with respect to which they were distributed for purposes of determining their basis and holding period. *Cf.* Rev. Rul. 71-350, 1971 INT. REV. BULL. No. 31, at 15-16. See text accompanying notes 50-52 *supra.*
225. I.R.C. § 307(a)&(b).
226. *See* Rev. Rul. 72-71, 1972 INT. REV. BULL. No. 8, at 7; Rev. Rul. 56-572, 1956-2 CUM. BULL. 182.
227. I.R.C. § 305(b).

rights are received to the extent of the fair market value of the rights not in excess of the distributing corporation's earnings and profits;[228] (2) any excess of the fair market value of the rights over the distributing corporation's earnings and profits reduces the basis of the stock with respect to which the stock rights were distributed;[229] and (3) the basis of the stock rights is their fair market value at the date of distribution.[230]

The subsequent tax consequences relating to stock rights are dependent upon the shareholder's utilization of the rights. They may be exercised, sold or allowed to lapse. Upon the exercise of stock rights, the basis of the rights is added to the subscription price to determine the basis of the stock acquired,[231] and the holding period for the new stock begins at the date the rights are exercised.[232] If the rights are sold, the shareholder will be required to recognize his gain or loss.[233] The holding period for nontaxable stock rights sold will be the same as that of the old stock with respect to which the rights were issued.[234] As to taxable stock rights sold, the holding period will date from the time the rights were distributed.[235] A further possibility is that in which the shareholder allows the rights to lapse.[236] The attendant tax consequences are dependent upon the taxability of the receipt of the rights. In the case of stock rights, the receipt of which was nontaxable under section 305(a), the regulations forbid an allocation of basis to such rights unless they are subsequently sold or exercised.[237] The effect is to give the rights a zero basis at the time they are allowed to lapse; therefore, the shareholder realizes no loss upon their lapse.[238] On the other hand, the lapse of taxable rights should give rise to a deductible loss.[239] The holding period of the taxable

228. *Id.* §§ 301(b)(1), 301(c)(1), 316(a). *See* Treas. Reg. § 1.305-2(c)(1) (1960); Treas. Reg. § 1.301-1(d) (1955). The rule prior to the *Internal Revenue Code of 1954* and the T.R.A. changes was that the taxable event occurred when the right was exercised or sold, the theory being that the right was a mere offer which did not constitute a distribution unless it was exercised. Palmer v. Commissioner, 302 U.S. 63 (1937); Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942). One writer has recently suggested that this rule presently applies. Note, *The Taxation of Stock Dividends and the Tax Reform Act of 1969—Foreboding Implications and Constitutional Uncertainties,* 24 VAND. L. REV. 545, 576 (1971). This conclusion, however, is probably erroneous since section 305(b) fixes the taxable event as the distribution.

229. I.R.C. § 301(c)(2).

230. *Id.* § 301(d); Treas. Reg. § 1.301-1(h)(1) to -1(h)(2)(i) (1955).

231. *See* I.R.C. § 1012.

232. *Id.* § 1223(6).

233. *Id.* §§ 1001 *et seq.*

234. *Id.* § 1223(5).

235. This is so since the "tacking" sanctioned by section 1223(5) only applies when the basis of the rights is determined under section 307, which is not the case with taxable stock rights.

236. *See generally* 94 BNA TAX MANAGEMENT PORTFOLIO, *supra* note 159, at A-40.

237. Treas. Reg. § 1.307-1(a) (1955) (last sentence).

238. *See* I.R.C. § 1001(a); Rev. Rul. 72-71, 1972 INT. REV. BULL. No. 8, at 7.

239. Because section 301(b)(1) treats the amount distributed as income to the extent permitted by section 301(c) as of the time of the *receipt* (rather than the *exercise*) of taxable stock rights under section 305(b), it is only reasonable that a deduction should be permitted if such rights are allowed to lapse and thereby be-

rights will begin with the distribution of the rights.[240]

The final consideration involves an analysis of those stock right distributions which section 305(b) converts into distributions to which section 301 applies. An obvious application of section 305(b) occurs when a corporation declares a dividend which grants shareholders an election to receive payment in cash or equivalent rights to acquire additional stock.[241] Activation of the section 305(b) (2) exception is also possible when stock rights are distributed. This potential activation is extremely subtle and equally alarming. As has already been noted, this exception applies when the distribution has the *result* of the receipt of property by some shareholders and an increase in the proportionate interests of other shareholders.[242] Consider the tax consequences of the following distribution. *X* Corporation, which has 300 shares of stock outstanding owned by *A*, *B* and *C* equally, distributes rights to these shareholders allowing each of them to acquire 100 additional shares at $100 per share. *X* Corporation stock has a fair market value of $125 per share at the date of the rights distribution. The term within which the rights must be exercised is 6 months. *A* immediately sells his rights to *D* receiving $20 per right, *D* and *B* exercise the rights, and *C* allows his rights to lapse.[243] Immediately after these events occur, *X* Corporation will have 500 shares of stock outstanding, owned as follows:

Shareholder	*No. of Shares*	*Ownership Percentage*
A	100	20
B	200	40
C	100	20
D	100	20

Since the distribution has had the *result* of the receipt of property by *A* (cash proceeds of sale)[244] and an increase in the proportionate interest of *B* (from 33⅓ percent to 40 percent), section 305(b)(2) might apply to render the entire distribution of stock rights taxable.[245] This conclu-

come valueless. *See* I.R.C. § 301(d); Treas. Reg. § 1.301-1(h)(1) to -1(h)(2)(i) (1955); *id.* § 1.305-2(c)(1) (1960). As to the type of loss and the issue of a "sale or exchange" upon lapse, see I.R.C. §§ 1222(2)&(4), 165(g), 1234; Rev. Rul. 70-521, 1970-2 CUM. BULL. 72; 94 BNA TAX MANAGEMENT PORTFOLIO, *supra* note 159, at A-40.

240. See note 235 *supra*.

241. I.R.C. § 305(b)(1). See text accompanying notes 81-87 *supra*.

242. I.R.C. § 305(b)(2).

243. Certain factors will often result in some shareholders allowing their rights to lapse. First, the shareholder receiving the rights may not have the financial ability to pay the subscription price required. If this financial condition occurs unexpectedly, the shareholder may not be able to sell the rights before they lapse. Further, the shareholder may hold the rights for a period of time during which the market price of the stock to which they pertain drops to or below the subscription price causing the rights to become worthless. In such event, the shareholder would be likely to allow the rights to lapse since he could not sell them and their exercise would not secure any advantage for him.

244. *See* I.R.C. § 317(a).

245. *See* Proposed Treas. Reg. § 1.305-3(b)(3), 36 Fed. Reg. 5222 (1971). This proposed regulation states that "there is no requirement that the shareholders

sion appears to be, at least, within a literal reading of section 305(b) (2). Although it seems doubtful that Congress intended such a drastic result, this foreboding consequence looms as a possible threat to *all* distributions of stock rights.

Within the remaining section 305(b) exceptions, a distribution of stock rights does not present unique problems. Such distributions falling within the usual parameters of these exceptions will be taxable. Accordingly, these exceptions must be reviewed carefully before stock rights are distributed. Moreover, the constructive stock dividend provision[246] must be closely scrutinized while stock rights are outstanding to insure that events relating to the stock already outstanding do not cause an increase in the proportionate interests of the holders of stock rights.[247]

Convertible Securities

Although section 305(d) (2) operates to encompass holders of convertible securities within the meaning of "shareholders" for purposes of section 305(b) and (c), it is important to recognize that convertible securities are not considered to be "stock" within the meaning of section 305(a).[248] The most significant impact of this provision is that a corporation which has outstanding convertible debentures upon which it pays interest can never distribute a nontaxable stock dividend[249] unless the convertible debentures are protected from dilution by stock dividends.[250]

receiving cash or property acquire the cash or property by way of a corporate distribution with respect to their shares, so long as they receive such cash or property *in their capacity as shareholders*." *Id.* (emphasis added). The proposed regulation then gives an example of this principle which involves a corporation related to the distributing corporation purchasing the stock dividend shares from stock dividend recipients who want cash, as part of a prearranged plan. *Id.* In the regulatory example, of course, since the purchase by the related corporation can be treated as a redemption of stock under either section 304(a)(1) or 304(a)(2), it can be stated that the selling shareholders received property in their capacity as shareholders; in addition, the factor of a prearranged plan was present. In the textual example, however, where *A* sells his stock rights to *D*, an unrelated outside *individual*, can it be said that *A* received the property (sale proceeds) in his capacity as a shareholder of *X* Corporation, where section 304 does not apply since a *related corporation* did not make the purchase, and therefore the sale is not treated as a redemption? *See* I.R.C. §§ 304(a)(1)&(2). Beyond that, on the facts given, there was no prearranged plan for *D* to purchase stock rights from *X* Corporation shareholders who wanted cash. These objections, among others, would appear to make the proposed regulation inapplicable here. Moreover, it is extremely doubtful that Congress intended all stock rights distributions to be taxable under section 305(b). *See* Rev. Rul. 72-71, 1972 INT. REV. BULL. No. 8, at 7. *See generally* BITTKER & EUSTICE ¶ 7.62, at 74; Tierney, *supra* note 111, at 186-87. Be that as it may, the textual example may literally come within the scope of section 305(b)(2) in view of its use of the word "result," particularly if the existence of a prearranged plan is shown.

246. I.R.C. § 305(c).

247. *See id.* § 305(d)(1)&(2); Proposed Treas. Reg. § 1.305-3(e) Exs. (4), (7), 36 Fed. Reg. 5223 (1971).

248. I.R.C. § 305(d)(1)&(2). See note 59 *supra*.

249. The Senate Finance Committee Report explicitly states that this is so. S. REP. No. 91-552, at 152.

250. *See* Proposed Treas. Reg. § 1.305-3(e) Ex. (4), 36 Fed. Reg. 5223 (1971). For amplification of what constitutes a "full adjustment" in preventing dilution by

This consequence is dictated by section 305(b) (2) since some shareholders (holders of convertible debentures) would receive cash and other shareholders (holders of common stock) would receive an increase in their proportionate interests. It appears, however, that there must be some certainty that at least some of the debenture holders will ultimately convert; otherwise, there would be no increase in proportionate interests.[251] The proposed regulations implicitly ignore such a requirement in stating unequivocally that convertible securities will be treated as outstanding stock of the distributing corporation for purposes of determining whether a disproportionate distribution occurs.[252] This problem may be avoided by protecting the convertible debentures from dilution by stock dividends.

Finally, it is unclear whether holders of convertible securities will be treated as receiving constructive stock dividends under section 305(c). Since convertible debentures are not considered to be "stock"[253] and section 305(a) applies only to distributions with respect to a corporation's stock, it is arguable that section 305(c) is inoperative with regard to convertible debentures. For example, if the conversion ratio of such securities is increased to reflect cash dividends paid on outstanding common stock, the question arises whether section 305(c) converts the increase into a constructive stock dividend to the holders of convertible debentures.[254] The situation is closely analogous to an increase in the conversion ratio of preferred stock, to which section 305(c) clearly applies.[255]

In summary, the T.R.A. attaches serious problems to the use of convertible securities, and the changes are likely to have a chilling effect upon their use in the future.[256]

TRANSITIONAL RULES

The complexity of the new stock dividend taxation rules does not end with the substantive provisions of the statute; tedious 21-year transitional rules are also imposed which, generally speaking, "grandfather"

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stock dividends, see Proposed Treas. Reg. § 1.305-3(d)(1), 37 Fed. Reg. 4964 (1972).

251. Several writers have argued that the imposition of a tax in such a situation is unconstitutional. Libin & Moorehead, *Stock Dividend Benefits Restricted but not Eliminated by the New Tax Law,* 32 J. TAX. 258, 263 (1970); Note, *supra* note 228, at 578-79.

252. Proposed Treas. Reg. § 1.305-3(b)(5), 36 Fed. Reg. 5222 (1971).

253. I.R.C. § 305(d)(1)&(2). See note 59 *supra.*

254. *See* Eustice, *supra* note 2, at 550. The revised proposed regulations imply an affirmative answer. Proposed Treas. Reg. § 1.305-7(b)(1), 37 Fed. Reg. 4966 (1972).

255. See text following note 169 *supra. See also* Proposed Treas. Reg. § 1.305-3 (e) Ex. (6), 36 Fed. Reg. 5223 (1971).

256. The T.R.A. enacted some new provisions and revised a previously existing provision which are likely to decrease the attractiveness of debt obligations. See I.R.C. §§ 249 (limitation of deduction upon reacquisition of debentures at a premium); 279 (disallowance of interest paid on corporate acquisition indebtedness); 385 (rules differentiating between debt and equity); 1232 (revision of original issue discount provision).

capital structures existing prior to the enactment of the T.R.A. Generally, the T.R.A. amendments to section 305 apply to actual and constructive distributions made after January 10, 1969.[257] For certain situations, however, transitional rules are provided which have the effect of delaying the application of the changes until January 1, 1991.[258] In the latter circumstances, section 305 as it existed prior to the T.R.A. will continue to apply.[259] Sections 305(b)(2), 305(b)(4) and 305(b)(5) are affected by the transitional rules. All other sections are effective as of January 10, 1969.

Section 305(b) (2) does not apply to actual or constructive distributions made before January 1, 1991, with respect to stock: (1) outstanding on January 10, 1969, or issued pursuant to a contract binding on the distributing corporation on that date; (2) which is additional stock of the corporation's principal class[260] of stock outstanding on January 10, 1969; (3) which is preferred stock convertible into stock described in (2) above at a fixed conversion ratio protected against dilution by stock dividends or stock splits; or (4) issued in a prior distribution described in (1) through (3) above.[261]

A curious exception is made to the transitional rule relating to section 305(b) (2). For example, if a corporation had two classes of stock outstanding on January 10, 1968, but had not, prior to January 10, 1969, made a distribution of property on one class and a distribution of stock on the other, then the transitional rule does not apply.[262] Ironically, this exception benefits those corporations and shareholders who had previously engaged in practices which the T.R.A. seeks to avoid. Further, the transitional rule relating to section 305(b) (2) ceases to apply when at any time after October 9, 1969, a corporation issues any stock (other than in a distribution of stock with respect to stock of the same class) which is not nonconvertible preferred stock, preferred stock convertible into a class of stock described in (2) above which has full antidilution protection, or additional stock of the class described in (2) above.[263]

Section 305(b) (4) does not apply to actual or constructive distributions with respect to preferred stock made before January 1, 1991, pursuant to the terms relating to the issuance of such stock which were in effect on January 10, 1969.[264] As to section 305(b) (5), the transitional rules applicable to section 305(b) (2) apply to the extent that the former section requires a determination as to whether the disproportionate dis-

257. Pub. L. No. 91-172, § 421(b)(1), 83 Stat. 615 (1969).
258. *Id.* § 421(b)(2) & (4), 83 Stat. 615, 616 (1969).
259. *Id.* § 421(b)(5), 83 Stat. 616 (1969).
260. The principal class is the corporation's class of stock which had the largest fair market value as of January 10, 1969. *Id.* § 421(b)(2)(A)(iii), 83 Stat. 615 (1969).
261. *Id.* § 421(b)(2)(A).
262. *Id.* § 421(b)(2)(B).
263. *Id.* § 421(b)(2)(C).
264. *Id.* § 421(b)(4).

tribution as described in section 305(b)(2) has occurred.[265]

To the extent that these transitional rules have delayed the full impact of the T.R.A. changes to section 305, the rules in existence prior to January 10, 1969, have continued application.[266] Thus, stock dividend taxation will exist under a bifurcated system for the 21 years following the enactment of the T.R.A.

CONCLUSION

The changes brought about by the T.R.A. in the field of stock dividends constitute a return to the proportionate interest test of pre-1954 law—but with a vengeance. Although the broad new exceptions of section 305(b) represent a commendable attempt by Congress to deal with abuses of section 305(a) in the context of the highly-sophisticated corporate capital structures of this era, one is left with a feeling of frustration and the suspicion that Congress has failed again. The cost—both in terms of further cluttering an already incredibly complicated code, and injecting uncertainty into corporate transactions—may be greater than the benefits to be obtained.

The specific consequences of the T.R.A. amendments to section 305(b) are many. Generally, the only stock dividend distributions that will have any chance of qualifying for nontaxability under section 305(a) will be those made on common stock.[267] Undoubtedly, the broadening of the section 305(b) exceptions will have the result of narrowing the application of section 306.[268] Finally, the return to the old proportionate interest test[269] and its expansion under the constructive stock dividend provision[270] with its subtleties, ambiguities and potentially broad scope, is almost certain to revive what in the past has been a particularly litigious area of the tax law. Indeed, it appears that Congress has set the stage for confrontation and it seems likely that the Commissioner is waiting in the green room for a bold taxpayer to furnish him the cue to "leap upon the stage with both wings flapping"[271] asserting a tax deficiency in one of the many obscure situations arising from stock dividend distributions. Accordingly, a substantial premium has been placed upon tax planning in the stock dividend area.

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265. Although the statute does not specifically so provide, this seems to be a logical result, and the original proposed regulations specifically took this position. Proposed Treas. Reg. § 1.305-8(b)(1), 36 Fed. Reg. 5227 (1971). Apparently, the revised proposed regulations are to similar effect. *See* Proposed Treas. Reg. § 1.305-8(b)(1), 37 Fed. Reg. 4966 (1972).

266. See note 259 *supra*.

267. *See* I.R.C. § 305(b)(4).

268. *Id.* § 306(c)(1)(A). *See* Del Cotto & Wolf, *supra* note 36, at 62; Eustice, *supra* note 2, at 551.

269. *See* I.R.C. § 305(b)(2)&(3).

270. *Id.* § 305(c).

271. This metaphor is attributable to James J. Freeland, Professor of Law, University of Florida; Visiting Professor of Law, University of Arizona (1970-71).