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The Deep Structure of Taxation: Dividend Distributions

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It's something like calculus. If you know why one thing is happening, you can figure out the other things.

Calvin Hill, on understanding football.¹

I. Introduction

A. Basic Tax Concepts

This article tries to develop a logical and consistent definition of one of the basic concepts of the Internal Revenue Code²—that of dividend distributions. Tax analysis begins with basic concepts, which are embodied in words like dividend, sale, lease, debt, and stock; to use these words is to define them. One cannot, for example, decide that property has been sold rather than leased without somehow saying what “sale” and “lease” mean.

Contrary to the tone of most criticism,³ which focuses on statutory complexity, this article illustrates that difficulty in understanding tax law most frequently arises from failure by those who use basic concepts to grasp their meaning, rather than from any excessive attempt at statutory precision. Accordingly, the idea that such law can be made more understandable or accessible by simplifying the lan-

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1. Wind, *The Sporting Scene*, NEW YORKER, Dec. 16, 1974, at 122, 147.

2. Current provisions of the Internal Revenue Code of 1954 will be cited by section number only.

3. See, e.g., Roberts, Friedman, Ginsberg et al., *A Report on Complexity and the Income Tax*, 27 TAX L. REV. 325 (1972) (New York State Bar Association, Tax Section, Committee on Tax Policy) [hereinafter cited as *Report on Complexity*].

guage of the Code does not respond to this essential difficulty and challenge of tax practice.⁴

A practitioner is not expected to understand, much less be an expert on, the entire Code, which purports to govern all economic activity. Perhaps fewer than 200 people in the country could work with the recently repealed minimum distribution rule, with its 50 pages of regulations in small type. But those who needed to, did; and the detail of the regulations achieved a high degree of predictability.⁵ By contrast, every practitioner should understand concepts so elemental that the Code does not, and probably should not, even articulate them. But too often courts have used these concepts without understanding the definitions they were creating or even that they were creating definitions. Moreover, since the same word has been given meaning in several contexts, inconsistent or contradictory definitions are more easily overlooked. Perhaps the best evidence of the importance, significance, and difficulty of the subject is the large proportion of Supreme Court tax cases that have had to determine the meaning of everyday words: interest,⁶ dividend,⁷ sale,⁸ gift,⁹ trade or business,¹⁰ loss and bad debt,¹¹ debt and stock,¹² primarily,¹³ solely,¹⁴ and property.¹⁵

4. The growth of the Code has resulted to some extent from the inability of reasonably short statutory language to resolve problems not perceived at the time of enactment. An illustration is the intended statutory overruling, by the present § 368(a)(2)(C) and the last clause of § 368(a)(1)(C), of the results of *Groman v. Commissioner*, 302 U.S. 82 (1937), *Helvering v. Bashford*, 302 U.S. 454 (1938), and *United States v. Hendler*, 303 U.S. 564 (1938). Other factors contributing to the Code's length include the following: provisions of limited application, variously called incentives and preferences, e.g., §§ 167(k), 921; the necessity to limit strictly to its intended beneficiaries relief from a rule of general application, as in § 341(e); a desire for extensive regulation, as in the case of private foundations and pension plans, e.g., §§ 401-415, 441-47; and finally, provisions for combatting the ingenuity of tax avoidance, as in §§ 304 and 306.

5. The *Report on Complexity's* criticism of the time and expense needed to understand such detail, based on the inability of the small businessman to afford expertise, is to some extent disingenuous. *Report on Complexity*, *supra* note 3, at 327. For example, provisions such as subpart F of the Code (§§ 951-964), of which the minimum distribution rule was a part, were enacted to prevent highly sophisticated methods of international tax deferral. For a businessman who does not wish to try siphoning off profit from high tax countries by the use of sales and service companies or repatriating profits to the United States without paying a dividend tax, subpart F should present no problem.

6. *Deputy v. duPont*, 308 U.S. 488 (1940).

7. *United States v. Davis*, 397 U.S. 301 (1970).

8. *Commissioner v. Brown*, 380 U.S. 563 (1965).

9. *Commissioner v. Duberstein*, 363 U.S. 278 (1960).

10. *Snow v. Commissioner*, 416 U.S. 500 (1974); *Whipple v. Commissioner*, 373 U.S. 193 (1963); *Higgins v. Commissioner*, 312 U.S. 212 (1941).

11. *Putnam v. Commissioner*, 352 U.S. 82 (1956).

12. *John Kelley Co. v. Commissioner*, 326 U.S. 521 (1946).

13. *Malat v. Riddell*, 383 U.S. 569 (1966).

14. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942).

15. *Crane v. Commissioner*, 331 U.S. 1 (1947).

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A Supreme Court decision cannot impose a completely uniform definition of a concept. In fact, many of its tax decisions raise questions about definitions generally accepted by the tax bar.¹⁶ But a disturbing tendency has arisen recently—expressed by the Supreme Court in *Snow v. Commissioner*,¹⁷ and by two well-respected judges, Henry Friendly and Theodore Tannenwald—to reject the idea that consistency of tax meaning is a realistic possibility.¹⁸ Judge Friendly, for example, concluded that “where the Internal Revenue Code is concerned, no controlling weight can be given to the usual presumption that, when the same words are used in several sections of a statute, they mean the same thing.”¹⁹

In a philosophical sense, meaning itself may be necessarily tentative and imprecise. However, as a matter of tax law the same word can and should refer to business transactions whose structural similarity can be articulated with reasonable precision. More specifically, it is submitted that a logical and consistent meaning of the term “dividend” can explain two lines of cases in which substantial definitional issues exist despite more than 60 years of income taxation. Those cases involve (a) distributions by a corporation incident to a sale or exchange of its stock, and (b) transfers of property between commonly-controlled companies. In order to analyze the cases, however, it is first necessary to understand what a dividend is and what it is not.²⁰

B. *Dividends, Form and Substance: Telling the Dancer from the Dance*

A dividend does *not* confer an economic benefit on its recipient. The distribution leaves the shareholder no richer, since his directly-owned assets increase only by the same amount that the beneficial ownership of those assets represented by his stock interest diminishes.

16. See, e.g., *United States v. Byrum*, 404 U.S. 937 (1972) (definition of “possession or enjoyment” for estate tax purposes).

17. 416 U.S. 500, 502-03 (1974).

18. *Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220, 1222-23 (2d Cir. 1975); *Telephone Answering Serv. Co.*, 63 T.C. 423, 434-35 (1975). Compare these cases with Judge Friendly's more synthetic approach in *Commissioner v. Ferrer*, 304 F.2d 125, 130-31 (2d Cir. 1962).

19. *Sirbo Holdings, Inc. v. Commissioner*, 509 F.2d 1220, 1223 (2d Cir. 1975).

20. Section 316(a) defines a dividend as a distribution of property by a corporation to its shareholders out of post-1913 or current earnings and profits. Sections 61(a)(7) and 301(c)(1) include a dividend in a recipient's gross income. This article focuses on the relation between the concept of dividend and the occurrence of a distribution of property; it is not primarily concerned with other issues involved in the taxation of dividends, such as whether earnings and profits are sufficient to cover all distributions, or whether the distribution results in a meaningful reduction of the shareholder's proportionate interest and is therefore a redemption not essentially equivalent to a dividend (§ 302(b)).

A dividend therefore is included in gross income not because it affects the shareholder's net worth (which is increased even by undistributed corporate profits), but because the distributed property no longer is in corporate solution.

It can be argued that obtaining control over the distributed property—being able to use or dispose of it as the shareholder wants—benefits the shareholder in a tangible way. The corollary, however, must be that the original conversion of money from personal to investment use through the purchase of stock worsened his economic position. In fact, an investor trades control and possession of his funds for the possibility of greater profit. Savings banks, for example, generally offer the highest interest to depositors who give up their withdrawal rights for the longest period. The recipient of a dividend regains control and possession over part of his investment but gives up the rate of return the corporation could have earned on that money.

An indication that investors might consider reinvestment of corporate profits of greater benefit to them than receipt of cash dividends is the existence of automatic dividend reinvestment plans offered by many New York Stock Exchange companies. Such plans offer shareholders the opportunity to reinvest dividends with the corporation rather than to receive the cash, and many shareholders accept the offer even though the reinvested amount will be included in their taxable income.²¹

The confusion of dividends with economic benefit may result in part from the market behavior of widely-owned stocks,²² although the tax cases usually concern companies with few shareholders. For the latter type of company, the distinction between corporate and shareholder control over funds narrows and may vanish. One indication that shareholders of closely-held²³ corporations in particular do not regard the purported economic benefit of a dividend as worth its tax cost is the Internal Revenue Code itself. In order to force shareholders of such corporations to confer the purported benefit

21. See § 305(b)(1).

22. The price of publicly traded shares often rises upon anticipation or declaration of an increased dividend and declines when an anticipated dividend is reduced or omitted. There is no logical reason, however, for an investor to pay a higher price for the shares simply for the opportunity to obtain cash, since he could achieve the same result by waiting until the dividend was distributed and then paying less for the shares. This market behavior is more likely a reaction to what the dividend indicates about the company's prospects.

23. The term closely-held corporation, in this context, includes a subsidiary of a publicly-held corporation, since the parent generally has effective control over the subsidiary's assets.

upon themselves, §§ 531 and 541 of the Code impose substantial penalty taxes for not doing so.²⁴

The reluctance of such companies to declare dividends reflects a correct perception that a dividend is fundamentally a taxable rather than an economic occasion. A shareholder in, say, the 40% bracket is better off causing his corporation to invest a dollar in respect of his stock interest than receiving the dollar himself and investing the 60 cents remaining after tax. For tax purposes, therefore, a dividend distribution should be regarded simply as an occasion for imposing tax. A dividend is nothing more or less than a *taxable event*, which individual shareholders usually seek to avoid and corporate shareholders may seek to incur in preference to capital gain.²⁵

Nevertheless, in both lines of cases discussed in this article—one involving distributions incident to a sale or exchange; the other, transfers between commonly-controlled companies—courts discuss whether or to whom a dividend distribution has been made in terms of economic benefits received and the underlying substance of the transaction. This attempt to attribute economic substance to what is only a change in the form of asset ownership must end in confusion and futility, as illustrated by an archetypal decision of each line of cases—*Waterman Steamship Corp. v. Commissioner*²⁶ and *PPG Industries, Inc.*²⁷ In both instances courts sought to determine the existence of a dividend not just with reference to whether property had been transferred out of corporate solution, but also with reference to tax avoidance, which necessarily assumes the existence of an underlying economic substance. But whereas *Waterman Steamship* held that a dividend had not occurred because the purported recipient *had* a tax avoidance motive, *PPG* held that a dividend had not occurred because the purported recipient did *not* have a tax avoidance motive. The fallacy is their common assumption that economic substance can be found in a transaction whose essence is form.

Part II of the article begins with a detailed analysis of *Waterman*, whose grafting of tax avoidance motive onto the concept of dividend fails to persuade for at least two reasons: first, what it considers tax

24. Although § 531 literally applies both to publicly and closely-held companies, it has been held inapplicable to the former. *Golconda Mining Corp.*, 507 F.2d 594 (9th Cir. 1974), *rev'd and remanding* 58 T.C. 139 and 58 T.C. 736 (1972). The Internal Revenue Service will not follow that case. Rev. Rul. 75-305, 1975 INT. REV. BULL. No. 30, at 12.

25. Corporations generally prefer to receive dividend rather than capital gain income, because § 243 or the consolidated return provisions of § 1502 allow them to deduct from income a minimum of 85%, and a maximum of 100%, of dividends received from a domestic corporation.

26. 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970). See pp. 867-73 *infra*.

27. 55 T.C. 928 (1970). See pp. 899-905 *infra*.

avoidance is now required by Treasury regulations; second, the tax result it proscribes could have been achieved by other means. It is therefore difficult to discover what economic substance the taxpayer in *Waterman* was trying to avoid; and the question then becomes why the decision associates substance with dividend distributions at all.

The explanation of *Waterman's* attempt to graft some notion of economic substance onto the definition of dividend distributions is set forth in sections B and C of Part II, which focus on the cases leading up to *Waterman*. Although the results of those cases were consistent with the form used by the taxpayer, their reasoning spoke of substance. Search for the substance of dividends has prevented courts from recognizing that, where the form of a negotiated distribution incident to a stock sale is not respected by a court, what justifies that disregard is the substance of *negotiations*, not any purported substance of dividends. The tax substance of negotiations is prescribed by the Supreme Court case of *Court Holding Co. v. Commissioner*;²⁸ and, as discussed below in section D of Part II, the principles of that case—not any economic substance—rationally explain when and to whom a distribution incident to a sale is a dividend.

Failure to perceive that there is no economic substance to a dividend has led to inconsistent and unpredictable decisions. Sometimes those decisions, like *Waterman*, defeat the legitimate expectations of the taxpayer; at other times, as in *PPG*, they defeat the legitimate expectations of the Government.

II. Dividend or Sales Price: Bootstrap Acquisitions

A distribution by a corporation incident to a shareholder's sale or exchange of its stock, if in redemption of the seller's shares, reduces the number of shares a purchaser must acquire to obtain control. If such a distribution takes the form of a dividend, it either lowers the value of the shares to be acquired or (when paid after the acquisition) enables the purchaser to recover part of his acquisition cost. In either case, the distribution uses the corporation's funds to finance its own acquisition; for that reason such transactions are frequently referred to as bootstrap acquisitions. Regardless of the procedure used, the economic results are identical: the buyer has to furnish less money of his own to purchase the corporation but winds up owning a smaller company. For example, if a corporation has an equity which buyer and seller agree is worth \$1,000, the seller will receive \$1,000

28. 324 U.S. 331 (1945).

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no matter what form the transaction takes. A distribution of, say, \$400, whether to seller or buyer, and whether as a dividend or in redemption of stock, means only that the buyer is paying \$600 from his own assets for a corporation whose equity is now worth \$600.

Since neither buyer nor seller is richer by reason of the distribution, their negotiations as to the form of an acquisition will be governed primarily by taxes—to whom and at what rate the corporate distribution (the \$400 in the above example) will be taxed.²⁹ The particular form a bootstrap acquisition takes therefore has no economic significance except its tax consequences. Given that the only substance to the form chosen is the anticipated tax result itself, the question becomes whether form alone can—or should—determine the tax result.³⁰

A. Waterman Steamship: *Dividend as a Function of Tax Avoidance*

The approach to an answer perhaps best begins with *Waterman Steamship Corp. v. Commissioner*,³¹ in which form was overridden. The seller in that case, Waterman Steamship Corporation, initially was offered \$3,500,000 for the stock of two of its subsidiaries, Pan-Atlantic Steamship Corporation and Gulf Florida Terminal Company, Inc. Waterman did not accept, but offered instead to sell the two companies for \$700,000, after payment of dividends by them to Waterman of \$2,800,000. The \$700,000 sales price equalled Waterman's basis in the stock of the two companies. The parties agreed to this arrangement, and on January 21, 1955, Pan-Atlantic declared

29. As stated in an analogous context: "[T]he presumed tax consequences of the transaction may . . . help to determine the total amount a purchaser is willing to pay for . . . a purchase." *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir.), *cert. denied*, 389 U.S. 858 (1967) (sellers of business held bound by amounts allocated in sale agreement to covenant not to compete).

30. A review of the techniques used, and the tax differences which they cause, is contained in Jassy, *The Tax Treatment of Bootstrap Acquisitions: The Redemption Route vs. The Dividend Route*, 87 HARV. L. REV. 1459 (1974).

Jassy recommends that, regardless of the form used, a distribution to a seller that does not reduce the buyer's purchase obligation should be treated as a redemption by the transferred corporation if the tests of § 302(b) are met. *Id.* at 1479-82. Jassy rests this recommendation on a desire to conform the bootstrap acquisition cases involving dividends to those involving redemptions. Not only does that result in a purported economic substance; as Jassy himself implicitly recognizes, *id.* at 1478 n.67, his recommendation also destroys the present conformity between dividends in taxable transactions and dividends in tax-free reorganizations. Extension of his recommendation to a dividend declared to the seller prior to a stock-for-stock exchange would mean that the dividend would constitute consideration other than voting stock paid by the acquiring company. Thus, the exchange could not qualify as a reorganization within the meaning of § 368(a)(1)(B), which permits the acquiring company to give only voting stock. See pp. 895-96 & notes 136-37 *infra*.

31. 50 T.C. 650 (1968), *rev'd*, 430 F.2d 1185 (5th Cir. 1970).

and paid to Waterman a dividend of \$2,799,820³² in the form of a promissory note due on February 20, 1955.

On the same day Waterman sold the stock of both companies to McLean Securities Corporation (Securities), whose principal stockholder, McLean, guaranteed Pan-Atlantic's dividend note to Waterman. McLean and Securities immediately loaned Pan-Atlantic enough money to pay the note just distributed to Waterman, taking back notes of Pan-Atlantic. Nearly six months later, in connection with a public offering of Securities shares, the underwriters—who did not want the note held by an individual—required McLean to exchange his \$2,500,000 Pan-Atlantic note for preferred stock of Securities.

Beyond doubt, Waterman structured the transaction to avoid capital gains tax on the amount—\$2,799,820—by which the \$3,500,000 cash received exceeded its tax basis in the stock of the two subsidiaries. Since the tax basis to Pan-Atlantic and Gulf of their assets was more than \$3,500,000, the companies could have sold their assets to Securities and distributed the cash to Waterman in liquidation without any of the three corporations recognizing income.³³ That avenue, however, was foreclosed by a nontax consideration: an asset sale would have required the approval of the Interstate Commerce Commission, a process which McLean did not want to undertake. Waterman intended to reach the same result by eliminating the promissory note from its income as a dividend from a corporation with which it filed a consolidated return.³⁴

The Tax Court majority opinion concluded that the \$2,799,820 note was a dividend rather than sales price on two principal grounds. First, it held that

in negotiating for sales of corporate stock, . . . the parties may properly so arrange the form of the transactions as to reduce or eliminate the taxable income resulting therefrom. . . . [S]ubstance should not be considered to differ from . . . form merely because the same result might have been accomplished by the parties by another method which would have produced a higher tax. . . .³⁵

32. Waterman's basis in the stock of the two companies actually proved to be \$700,180. The purchase price was increased by \$180, and the dividend decreased to \$2,799,820, to reflect this fact; but neither the Tax Court nor the court of appeals discussed this minor deviation from the contract.

33. Waterman's gain would not be recognized by reason of § 332, which permits the tax-free liquidation of subsidiaries in which the parent owns 80% or more of the shares.

34. § 1502; Treas. Reg. § 1.1502-14, as amended, T.D. 7246, 1973-1 C.B. 381.

35. 50 T.C. at 665.

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Second, because “there was no actual acceptance of the offer or legally binding contract of sale . . . until after the dividend was declared and the note delivered,”³⁶ it stated:

Where the parties to the sale are in agreement as to whether a dividend is to be paid to the seller and the equitable interest in the stock as well as legal title thereto remain in the seller until after the dividend is declared and paid, the dividend is that of the seller.³⁷

In other words, the Tax Court held that form does govern and that Waterman used the correct form. Judge Tannenwald, joined by three others, dissented. He reasoned that no dividend had in fact been paid, because the original purchase price offered was \$3,500,000 and the funds which Pan-Atlantic used to pay its note to Waterman were supplied by the purchaser.

The Fifth Circuit reversed, agreeing with the Commissioner that “irrespective of the form of the transaction, the substance . . . was a payment by Securities to Waterman of \$3,500,000 for the stock of the subsidiaries” and that in substance Pan-Atlantic did not pay a dividend to Waterman, but acted as a conduit for payment of the purchase price.³⁸ The court stated that “tax consequences must turn upon the economic substance of a transaction and not upon the time sequences or form,” that a “new horizon of tax avoidance opportunities would be opened by allowing a tax free dividend, under Section 1502,” and that a corporation would be able to “circumvent capital gains treatment through a pre-sale extraction of earnings and profits.”³⁹

The Internal Revenue Service’s 1975 nonacquiescence in the Tax Court majority opinion⁴⁰ does not mean that it subscribes to every statement in the Fifth Circuit’s reversal; but its later characterization of *Waterman* as a case in which “the form of the transaction was a sham designed to disguise the true substance of the transaction”⁴¹ similarly views substance and tax avoidance as the key concepts to understanding the nature of a dividend. Particularly when applied to the facts in *Waterman*, the notion that a dividend embodies an economic substance which must be preserved from tax avoidance schemes is inconsistent with some compelling arguments:

1. But for the necessity of obtaining Interstate Commerce Com-

36. *Id.* at 661.

37. *Id.* at 666.

38. 430 F.2d at 1191, 1192.

39. *Id.* at 1192, 1195.

40. 1975-1 C.B. 3.

41. Rev. Rul. 75-493, 1975 INT. REV. BULL. No. 46, at 8.

mission approval, Waterman could have sold the assets of its subsidiaries and received the \$3,500,000 without paying any tax. Waterman therefore sought only the same tax result that it unquestionably could have achieved through a different *form*. Ultimately, then, all that was avoided in *Waterman* was the necessity for obtaining ICC approval of the transaction. Denying the benefits of consolidated return dividends is a rather remote method of enforcing national transportation policy, even had the Fifth Circuit considered that it was doing so. The Internal Revenue Service has accepted that § 269, its generalized tax avoidance statute, does not apply if the taxpayer could have achieved the same tax benefit by using another form.⁴² Although that acceptance covers only transactions within the scope of § 269, the Service's ability to claim that a transaction must be recharacterized to accord with its true substance under court-developed tax avoidance principles should be similarly limited.

2. Insofar as possible, the consolidated return regulations treat an affiliated group of corporations as one taxpayer. Assuming the Waterman group had filed consolidated tax returns during the years in which Pan-Atlantic had accumulated the \$2,799,820 of earnings and profits that it distributed to Waterman,⁴³ then—viewed as a unit—the Waterman group had already paid tax on those earnings. The transaction at issue, then, was an attempt by the Waterman group to avoid being taxed again on the same earnings. Under the then-applicable consolidated return regulations, taxation of those earnings to the Waterman group did not correspondingly increase Waterman's basis in the Pan-Atlantic stock. This discontinuity has been corrected.⁴⁴ Had the present regulations been in effect,⁴⁵ Waterman's tax basis in the stock would have been at least \$2,799,820 higher, it could have

42. Section 269(a) permits the Service to disallow any "deduction, credit, or other allowance" that arises from certain acquisitions by a taxpayer of control in or property of a corporation if "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person . . . would not otherwise enjoy." In *Cromwell Corp.*, 43 T.C. 313 (1964), *acquiesced in*, 1965-2 C.B. 4, (discussed p. 875 *infra*), the court found that one form of a bootstrap acquisition did not violate § 269 because other forms with the same tax consequences had received judicial approval. In light of this reasoning, the *Waterman* court's citations of *Goldstein v. Commissioner*, 364 F.2d 734 (2d Cir. 1966), *cert. denied*, 385 U.S. 1005 (1967), which concerned a transaction entered into with the expectation of economic loss, and *Gregory v. Helvering*, 293 U.S. 465 (1935), as preventing Waterman from doing indirectly what it could not do directly, are wildly inappropriate.

43. The Tax Court opinion states only that the Waterman group filed a consolidated return for the year of sale. 50 T.C. at 651.

44. Treas. Reg. § 1.1502-32(b)(1)(i), *as amended*, T.D. 7246, 1973-1 C.B. 381.

45. In relevant part, the present regulations were issued in 1966, well before the Fifth Circuit's decision. T.D. 6909, 1967-1 C.B. 240, 248.

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sold the Pan-Atlantic stock to Securities without realizing any gain, and no pre-sale distribution to Waterman would have been necessary. The Fifth Circuit thus characterized as impermissible tax avoidance an attempt to achieve the result now mandated by the present consolidated return regulations.

3. No tax principle decrees that dividends occur only in the form of distributions. Under present law, if Pan-Atlantic had been a foreign corporation, Waterman's gain upon the sale of its Pan-Atlantic stock would have been taxed as a dividend;⁴⁶ assuming that Pan-Atlantic had paid foreign tax equal to the United States tax which it did pay in respect of the \$2,799,820, Waterman's gain would have gone untaxed in much the same way a consolidated return dividend would have.⁴⁷ Moreover, a shareholder can include dividends in his income just by filing a consent with the Internal Revenue Service. Although the statutory language indicates that a consent dividend is intended to furnish relief from the accumulated earnings and personal holding company taxes, nothing in the Code or regulations precludes its use in a *Waterman*-type transaction.⁴⁸ In an analogous situation, the Ser-

46. § 1248(a). The dividend, measured by the amount of post-1962 earnings and profits, is limited to the amount of gain realized. The statutory association of dividends with gain links two logically independent concepts, since taxation of a dividend distribution does not depend upon the recipient having increased his net worth. See pp. 879-80 *infra*. Nevertheless, the linkage persists, not only in the cases discussed in this article, but also in §§ 1248 and 356(b) of the Code.

47. Had Pan-Atlantic been a controlled foreign corporation that after 1962 earned \$5,600,000 and paid foreign corporate tax of \$2,800,000, it would have had \$2,800,000 of after-tax earnings. Pursuant to § 1248, Waterman's gain on the sale of stock to Securities would have been taxed as a dividend. If Waterman had then elected the foreign tax credit, §§ 78 and 902 would have required Waterman to include the entire \$5,600,000 of pre-tax earnings in its income; but Waterman would have received credit against its United States tax liability for the \$2,800,000 of foreign taxes paid. Assuming a 50% United States tax rate, those provisions would have had the effect of eliminating United States tax on the sale.

Waterman attempted to achieve the same result by an intercompany dividend from a United States company. The elimination of an intercompany dividend from Waterman's income is a recognition that \$2,800,000 of United States tax had been paid in respect of the distributed profits, just as the foreign tax credit is a recognition that \$2,800,000 of foreign taxes had been paid in respect of the subsidiary's profits. It should therefore not be considered tax avoidance to make the tax effects similar.

48. Section 565(a) provides that the amount specified in a consent shall constitute a consent dividend for purposes of the deduction afforded by § 561, which deduction is referred to in sections dealing with accumulated earnings and personal holding company taxes, §§ 535(a) and 545(a). Section 565(c), however, provides that the consent shall be effective for purposes of the entire Code, and § 7806(b) makes the grouping of the consent dividend provisions near specific penalty taxes of no significance. Had Waterman filed a consent to a dividend of \$2,799,820, the tax treatment—assuming that the consent were held effective—would have been as though Pan-Atlantic had distributed \$2,799,820 in cash to Waterman, which then contributed that amount to the capital of Pan-Atlantic. § 565(c). Although the dividend would have been eliminated from income by the consolidated return, the contribution to capital would have increased Waterman's basis in the Pan-Atlantic stock to \$3,500,000 and eliminated the gain on the sale of the stock. Treas. Reg. § 1.565-3(a) (1964).

vice has not required a taxpayer to demonstrate that he is in danger of incurring a penalty for not declaring dividends in order to elect the intended relief.⁴⁹

Thus, even without a corporate distribution, dividends (a) can arise in a sale context, and (b) can be created without the form of a distribution. Accordingly, the Fifth Circuit's conclusion, in the face of a corporate distribution, that "in substance Pan-Atlantic neither declared nor paid a dividend to Waterman,"⁵⁰ rests on a concept of dividend incompatible with the results mandated in analogous situations.

The court did not specifically discuss the tax treatment of McLean and Securities, the buyers. But if a note can be issued as a dividend,⁵¹ the reasoning of the Fifth Circuit that the cash advanced by McLean and Securities should be treated as purchase price makes inescapable a conclusion that McLean and Securities did not give Pan-Atlantic any consideration for the \$2,799,820 of notes received. Therefore, Pan-Atlantic must be considered to have distributed those notes as a dividend to Securities, of which \$2,500,000 was in turn distributed to McLean.⁵²

Waterman, then, implicitly accepted the Service's view that the economic substance of a distribution to the seller incident to a bootstrap acquisition is a dividend to the *buyer*. More recently, the Service has alternatively explained *Waterman* on the ground that the buyer furnished the funds used by Pan-Atlantic to pay its note to Waterman,⁵³ overlooking—as did Judge Tannenwald's dissent—the fact

49. Rev. Rul. 75-111, 1975-1 C.B. 251 (taxpayer permitted to make minimum distribution election regardless of whether it has subpart F income for year).

50. 430 F.2d at 1192.

51. The Fifth Circuit stated that whether as a matter of law a note may be issued in payment of a dividend was not litigated in the Tax Court. *Id.* at 1185 n.1. However, there is authority that indicates that a note may be treated as a dividend. § 956 (obligations of United States companies treated as dividends in certain calculations of income of controlled foreign corporations); *Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956) (debentures found to constitute bona fide dividend); *Treas. Reg. § 1.301-1(d), as amended*, T.D. 7293, 1973-2 C.B. 228 (describing how to calculate amount of dividend when company distributes its obligations). Even if the issuance of a note for no consideration would not be taxed as a dividend, its payment would be.

52. Since Securities, the actual purchaser, was a corporation, the tax effect of a dividend to it from Pan-Atlantic could be nullified by the same consolidated return provision that Waterman was attempting to use. *See Cromwell Corp.*, 43 T.C. 313 (1964), *acquiesced in*, 1965-2 C.B. 4, in which an individual avoided dividend tax by forming a holding company to borrow funds and make the stock purchase. The borrowing was repaid by means of a dividend from the purchased corporation to its holding company parent, which dividend was eliminated from consolidated taxable income. The fact that McLean, who ended up owning the notes of Pan-Atlantic, had an interest in Pan-Atlantic only through Securities would mean that Pan-Atlantic constructively distributed the notes to Securities, which in turn distributed them to McLean.

53. Rev. Rul. 75-493, 1975 INT. REV. BULL. No. 46, at 8. *See p. 893 infra*.

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that the note rather than the cash was intended to be the dividend.⁵⁴ This explanation, however, represents only the latest in a long series of inconsistent perceptions by the Service of the economic substance of a dividend in a bootstrap acquisition. Because intercorporate dividends are taxed at a rate below the capital gains rate, the Service generally prefers that distributions to corporations be characterized as purchase price (and hence taxable at capital gain rates) rather than as dividends, but that distributions (whether actual or constructive) to individuals be treated as dividends. Thus, as discussed in the following sections, the Service has frequently perceived the substance of a bootstrap distribution as what is most beneficial to the federal revenues. In some cases (*Zenz v. Quinlivan*⁵⁵ and *Steel Improvement & Forge Co. v. Commissioner*⁵⁶), this ad hoc approach has resulted in the Service arguing that the substance of a distribution to the seller incident to a bootstrap acquisition was a dividend to the seller; in others (*Arthur J. Kobacker*,⁵⁷ *Cromwell Corp.*,⁵⁸ and by implication *Waterman*), a dividend to the buyer.

The reason why the Service, as well as buyers and sellers, has been able to argue either side as to the economic substance of a distribution in the context of a bootstrap acquisition is simple: *there is no independent economic substance to a distribution*. Its economic effect is the tax result, but the rationales advanced by the cases have so obscured this fact that the law in the Fifth and Sixth Circuits is almost in chaos. Moreover, the Service could not entirely contain the consequences of *Waterman* even if it wished to do so, because individual sellers will continue to cite that case to show that formally declared dividends paid to them should be treated as capital gain.⁵⁹ To see how the confusion has come about, in order to undo the damage, it is necessary to go into a little tax history.

54. The reasoning of the Fifth Circuit differs from Judge Tannenwald's Tax Court dissent, which stated as "plain unadulterated fact" that "no dividend was declared or paid by Pan-Atlantic to Waterman or *anyone else*" (emphasis added). 50 T.C. at 666. That statement, based on McLean's original offer of \$3,500,000 and the funds supplied by the purchaser, does not take into account the \$2,500,000 Pan-Atlantic note to McLean, which the underwriters recognized as real enough. Including its debt to Securities, Pan-Atlantic had \$2,799,820 less in net worth after the transaction than it had before; it therefore must have made a distribution to *someone*. That fact would have stood out more clearly if, rather than supplying Pan-Atlantic with cash to pay the note distributed to Waterman, McLean and Securities had simply bought the note from Waterman.

55. 213 F.2d 914 (6th Cir. 1954).

56. 314 F.2d 96 (6th Cir. 1963).

57. 37 T.C. 882 (1962), *acquiesced in*, 1964-2 C.B. 6.

58. 43 T.C. 313 (1964), *acquiesced in*, 1965-2 C.B. 4.

59. See *Casner v. Commissioner*, 450 F.2d 379, 389-92, 395-96 (5th Cir. 1971); pp. 888-93 *infra*.

B. *From Zenz to Cromwell: The Service's Acceptance of Form*1. *The Meaning of Zenz*

More than 20 years ago, in *Zenz v. Quinlivan*,⁶⁰ the Sixth Circuit rejected the Government's attempt to recharacterize a redemption as a dividend. In *Zenz*, an individual shareholder in a close corporation first sold part of her shares in that corporation to a third party and then, pursuant to the same plan, had her remaining shares redeemed by the corporation. The lower court, finding this procedure a circuitous and unsuccessful attempt to avoid taxable dividend treatment, held that the redemption distribution should be treated as a dividend to the seller. Reversing, the Sixth Circuit stated:

[W]e are satisfied that where the taxpayer effects a redemption which completely extinguishes [his] interest in the corporation, and does not retain any beneficial interest whatever, that such transaction is not the equivalent of the distribution of a taxable dividend as to him. . . .

. . . .
. . . [Treatment of a redemption as a taxable dividend] contemplated that the shareholder receiving the distribution will remain in the corporation⁶¹

Three points about *Zenz* are significant for this analysis: first, the Sixth Circuit's reference to "beneficial interest," which later was to become the same circuit's criterion of substance in *Steel Improvement & Forge Co. v. Commissioner*;⁶² second, the Service's announcements that it would follow *Zenz* under both the Internal Revenue Codes of 1939 and of 1954;⁶³ and third, that despite its purported criterion of economic substance, *Zenz* was at bottom a decision upholding form—it permitted *but did not require* distributions to a seller incident to a bootstrap acquisition to be characterized as a redemption of the seller's stock. Indicative of this respect for form is the fact that, prior to *Steel Improvement*, both sellers and buyers in bootstrap acquisitions who received distributions in the form of a dividend (rather than, as in *Zenz*, a redemption) had little success in arguing that substance required integration of the dividend and stock sale to reach a *Zenz*-

60. 213 F.2d 914 (6th Cir. 1954), *rev'g* 106 F. Supp. 57 (N.D. Ohio 1952).

61. *Id.* at 917.

62. 314 F.2d 96 (6th Cir. 1963). See pp. 885-88 *infra*.

63. Rev. Rul. 54-458, 1954-2 C.B. 167 (1939 Code); Rev. Rul. 55-745, 1955-2 C.B. 223 (1954 Code).

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type result.⁶⁴ Soon after *Zenz*, the Sixth Circuit itself replied to that argument as follows:

[Since taxpayers could have achieved their purpose by the *Zenz* form], it can be argued that to permit the decision of the Tax Court to stand is to permit form to triumph over substance. Yet, to the extent here implied, it is form which often must prevail, when the delicate question involved is whether the extraction of a corporation's earned surplus has been accomplished at less than the rates taxed upon ordinary income.⁶⁵

The Service, on the other hand, which had conceded that the *Zenz* form could avoid a taxable dividend, nevertheless persisted in claiming that other methods nontaxable in form must as a matter of substance be recharacterized as taxable dividends. In *Arthur J. Kobacker*,⁶⁶ for example, an individual buyer of a corporation assigned his purchase contract to a holding company formed to borrow, purchase the stock, and repay the loan with funds of the acquired corporation. Repayment was accomplished by merging the holding company into the acquired subsidiary, which succeeded to the debt by operation of law. A similar nontaxable form was employed in *Cromwell Corp.*,⁶⁷ in which a holding company made the purchase of the corporation in question and repaid its acquisition loan by causing the subsidiary to pay a dividend to it. The dividend was eliminated from the holding company's income because the two companies filed a consolidated return.

In each case the Service characterized the use of an acquired company's assets to finance the purchase of its own stock as a taxable dividend, considered the conjunction of the stock purchase with a downstream merger or consolidated return dividend, respectively, to fit that characterization, and attempted to find a dividend to tax.⁶⁸

64. In *Sam E. Wilson, Jr.*, 27 T.C. 976 (1957), for example, the taxpayer received a distribution in the form of a cancellation of indebtedness after he had contracted to sell his stock. He argued that since the distribution reduced the amount otherwise payable by the buyer under the contract, it should be regarded as a prepayment of purchase price. The court, disagreeing, noted that "[w]e cannot make such a holding because the contract specifically provides otherwise." *Id.* at 982 (emphasis added). In *Television Indus., Inc. v. Commissioner*, 284 F.2d 322 (2d Cir. 1960), the court rejected the redeeming buyer's argument that in substance its transaction should be treated as though the *Zenz* form had been used.

65. *Woodworth v. Commissioner*, 218 F.2d 719, 724 (6th Cir. 1955).

66. 37 T.C. 882 (1962), *acquiesced in*, 1964-2 C.B. 6.

67. 43 T.C. 313 (1964), *acquiesced in*, 1965-2 C.B. 4.

68. In *Kobacker*, the purported dividend was the payment by the acquired company of the holding company's debt assumed in the merger. The alleged recipients were the former shareholders of the holding company, who by reason of the merger became direct owners of the acquired company. 37 T.C. at 892-93. In *Cromwell*, the Service argued that

Both opinions rejected that position, and by acquiescence the Service also repudiated it. In the process, however, two things happened: the result of *Zenz* was elevated from form to substance, and substance became more firmly associated with economic benefit.

2. *Form Governs, But the Language is Substance and Benefit*

Both *Kobacker* and *Cromwell* upheld the effectiveness of the form chosen by the respective taxpayers. The language used by those cases, however, indicates that the decisions were based on the substantive question of whether the ultimate purchaser received an economic benefit. *Kobacker*, citing *Zenz* twice in a key paragraph, accepted the taxpayer's argument that his own transaction basically was the non-taxable "buying into a corporation simultaneously with complete retirement of its old shareholders."⁶⁹ But *Zenz* did not mean that all distributions incident to bootstrap acquisitions were *required* to be transmuted into the form of seller redemptions; in *Steel Improvement & Forge Co. v. Commissioner*, for example, the Sixth Circuit recognized that such a distribution was dividend income to *one* of the two parties.⁷⁰ Moreover, the reason asserted in *Zenz* to explain why a distribution need not in substance be a dividend to the seller—that the recipient was terminating his interest in the corporation—does not apply to the buyer.

Thus, *Zenz* does not make *Kobacker* logically inevitable; a more practical justification for the *Kobacker* result was the Service's failure to take a consistent position that the substance of distributions incident to an acquisition is always a dividend to the buyer or, if it had reversed its acquiescence to *Zenz* after more than 15 years, always a dividend to the seller. By not determining that a bootstrap acquisition can have only one substance for tax purposes, the Service had implicitly conceded that the same economic transaction can have different tax consequences depending on the way the transaction is structured; and if tax result flows from structure rather than economic realities, the tax substance of a bootstrap acquisition *is* the structure—in other words, the form—used.

Rather than deciding on the basis of the Service's implicit con-

since the holding company was formed to avoid the taxable dividend needed to finance the purchase if the individual shareholders of the holding company had made the acquisition directly, § 269 should be applied to prevent elimination of the dividend in a consolidated return. 43 T.C. at 317, 321.

69. 37 T.C. at 893. See *Cromwell Corp.*, 43 T.C. 313, 319 (1964), *acquiesced in*, 1965-2 C.B. 4 (same argument presented).

70. 314 F.2d 96 (6th Cir. 1963). See pp. 885-86 *infra*.

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cession, however, the court in *Kobacker* looked for an economic substance to the distribution:

Petitioners were personally unable to meet the \$475,000 price For the \$175,000 which they paid for the stock of [the holding company], petitioners acquired no more than an equity in [the purchased company] subject to its [\$300,000] indebtedness. . . . The later merger of [the holding company] into [the purchased company] resulted in no greater economic benefit to petitioners, aside from operational savings. Their interest in [the purchased company] was still subject to the indebtedness incurred by [the holding company] and assumed [in the merger].⁷¹

In other words, the transaction did not result in a dividend because it left the buyers no richer than before!

Cromwell still more explicitly associates the underlying substance of a dividend with economic benefit. That decision could have rested on the limited ground that no tax avoidance was involved, since the same result was available through the alternatives of *Kobacker* or *Zenz*.⁷² The *Cromwell* court, however, also went on to give its idea of what the underlying substance of a dividend was, first by quoting the above passage from *Kobacker*, and then by citing *Milton F. Priester*⁷³ and referring to two cases on which *Priester* relied, *Holsey v. Commissioner*⁷⁴ and *Niederkrone v. Commissioner*.⁷⁵ All three cases held that the redemption of a retiring shareholder's stock did not constitute a constructive dividend to the remaining shareholders. In *Priester*, the reason was that the remaining shareholder "received no financial or economic benefit from the transaction";⁷⁶ in *Niederkrone*, there was no "receipt of financial or economic advantage."⁷⁷ In *Holsey*, the corporation exercised an option, assigned to it by one of its two shareholders, to purchase the other shareholder's stock at a bargain price. The court conceded that the remaining shareholder

71. 37 T.C. at 895. The court added that although taxpayer's stock might become more valuable as the debt was repaid and the corporation was able to pay greater dividends, such appreciation would be taxed only when the stock was sold. This assumes that payment of an obligation increases net worth; but stock does not appreciate by payment of a debt any more than it depreciates when the corporation or shareholder borrows money. In both instances the change in assets is matched by a corresponding change in liabilities.

72. *Cromwell* involved the application of § 269, the Code's generalized tax-avoidance statute, which does not apply where the taxpayer could have received the same tax result by using another form. See p. 870 *supra*.

73. 38 T.C. 316 (1962).

74. 258 F.2d 865 (3d Cir. 1958).

75. 266 F.2d 238 (9th Cir. 1958), *cert. denied*, 359 U.S. 945 (1959).

76. This description of *Priester* is set forth in *Cromwell*, 43 T.C. at 319.

77. 266 F.2d at 244, *quoted in Priester*, 38 T.C. at 328.

had benefited "indirectly" by an increase in the value of his stock, yet it went on to state:

But where, as here, the taxpayer was never under any legal obligation to purchase the stock held by the other stockholder, . . . the distribution did not discharge any obligation of his and did not benefit him in any direct sense.⁷⁸

Priester, Niederkrome, Holsey, and by implication the Service's acquiescence in *Cromwell* speak in terms of economic benefit. By contrast, *Revenue Ruling 69-608*,⁷⁹ which deals with the same question of when a redemption of a retiring shareholder's stock is a constructive dividend to the remaining shareholder, does not speak in such terms. It does, however, view a dividend as more than a purely formal transaction. The criterion in the ruling is that if the remaining shareholder is subject to an "unconditional obligation" to purchase the stock, "the satisfaction by the corporation of his obligation results in a constructive distribution to him"; on the other hand, where his obligation is only secondary—for example, by having to purchase stock only if the corporation does not—the redemption is not a constructive distribution to him.⁸⁰

Under the approach of *Revenue Ruling 69-608*, identical corporate redemptions can have different tax results because of the existence of executory purchase contracts *which are never consummated*. A tax difference which rests upon the terms of executory contracts can best be explained not by any economic substance, but by reference to the tax rules developed with respect to such contracts, regardless of whether the contracts are between present shareholders or, as in *Zenz*, between a present and prospective shareholder. Instead, the search for a rationale based on some economic substance of dividends has invited confusion. To illustrate, the talk of the substance of dividends in *Zenz*, *Kobacker*, and *Cromwell* obscured the fact that in all three cases form determined the result. Similarly, the equation of that substance with economic benefit obscured the fact that, unless inconsistent with the sale terms negotiated by the parties, form *should* determine result; and it has prevented both the courts and the Service from seeing that only the tax rules developed to analyze the sub-

78. 258 F.2d at 868. Rev. Rul. 58-614, 1958-2 C.B. 920, states that the Service will follow *Holsey*.

79. 1969-2 C.B. 43.

80. Compare *id.* Situation 5 with *id.* Situation 2. The redemption can be a constructive dividend, however, if the corporation pays more than fair market value for the stock received.

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stance of a sale—not any concept of economic benefit—correctly explain why satisfaction by a corporation of a shareholder's executory contract to purchase its stock should be taxed to him as a dividend.

C. *The Origin of Economic Benefit as the Substance of Dividends*

The unfortunate linkage of dividend with economic benefit, which implied that a dividend increased net worth, has distracted courts from an initial perception of dividend as an increase only in the amount of a shareholder's assets outside corporate solution. The linkage had its beginnings in 1929, when the Supreme Court, in *Old Colony Trust Company v. Commissioner*,⁸¹ held that the payment of an employee's taxes by his employer should be treated as though the funds had been paid directly to the employee and used by him to discharge the obligation. That discharge, which did (unlike a dividend) increase the employee's net worth, later was described correctly by the Supreme Court as for his "benefit."⁸²

Next, *Wall v. United States*⁸³ applied the *Old Colony* rationale to a case where discharge of the obligation did not increase the debtor's net worth, but did result in funds moving from corporate solution to the taxpayer. In *Wall*, one shareholder in a corporation had purchased all the stock of the other shareholder for its fair market value, giving a note in return. Rather than pay the note with personal funds, the debtor later surrendered the purchased stock to the corporation in consideration of its paying his debt. The court reasoned that a third party's payment of a debt owed by the taxpayer

is regarded as the same as if the money had been paid to the taxpayer and transmitted by him to the creditor; and so if a corporation, instead of paying a dividend to a stockholder, pays a debt for him out of its surplus, it is the same for tax purposes as if the corporation pays a dividend to a stockholder, and the stockholder then utilizes it to pay his debt.⁸⁴

Although holding that payment of the debtor's note was a dividend distribution to him, the court refrained from use of the word "benefit." Indeed, the taxpayer argued unsuccessfully that the usual dividend

81. 279 U.S. 716 (1929).

82. *Douglas v. Willcuts*, 296 U.S. 1, 9 (1935).

83. 164 F.2d 462 (4th Cir. 1947). *Wall* cites both *Douglas v. Willcuts*, 296 U.S. 1 (1935) and *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), for the proposition that "payment of a taxpayer's indebtedness by a third party pursuant to an agreement between them is income to the taxpayer." 164 F.2d at 464.

84. 164 F.2d at 464.

rule should not apply to him, because he had not received any gain by reason of his purchase and the corporation's subsequent redemption of those shares.⁸⁵ As a matter of economics, of course, the taxpayer could not have received any gain from the corporation's assumption of the debt and cancellation of the redeemed shares, because he was the sole shareholder.⁸⁶ The gain that resulted from causing the corporation to assume his debt was exactly offset by the loss in value to his solely-owned company, which now owed a debt to a third party for which it had never received any corresponding asset. The effect, then, was a transfer of net worth out of corporate solution and a corresponding increase in the amount of the shareholder's beneficially owned assets outside corporate solution. Thus the *Wall* court correctly perceived that it is the transfer of assets out of corporate solution, not any economic benefit to the shareholder, that is the measure of a dividend.

By 1965, however—18 years after *Wall*—the identification of dividend with benefit (in *Kobacker*, *Cromwell*, *Priester*, and other cases) had become sufficiently pervasive that a court felt compelled to justify dividend taxation by characterizing a corporation's discharge of its shareholder's obligation as an economic benefit to the shareholder even though it did not increase the shareholder's net worth. In *Sullivan v. United States*,⁸⁷ a corporation satisfied its shareholder's executory obligation to purchase additional stock in the company at its fair market value. Responding to the argument that a dividend required an economic benefit to the shareholder as well as the discharge of an obligation owed by the shareholder, the district court stated that the "economic benefit . . . in this case *was* the discharge by the corporation . . . of [the obligation] to purchase . . . stock."⁸⁸ Relief

85. The taxpayer argued that he received no taxable gain from his transactions because he paid more for the retiring shareholder's interest than the proportionate claim of those shares on the company's assets. He further contended that any economic benefit from his dealings could only be measured by waiting until he ultimately disposed of his shares. *Id.* at 465. To this argument the court responded:

While this statement may be true, it is entirely beside the point. We are not now concerned with the broad question whether the business . . . will ultimately result to his advantage and show a profit on his investment . . . , but with the much narrower question whether in 1939 the taxpayer in legal effect received a dividend from the corporation through the payment by it of the \$5,000 note

Id.

86. In rejecting the taxpayer's argument that his surrender of stock constituted consideration for the corporation's assumption of his debt, the court pointed out that the surrender of stock did not affect his 100% interest. *Id.*

87. 244 F. Supp. 605 (W.D. Mo. 1965), *aff'd*, 363 F.2d 724 (8th Cir. 1966), *cert. denied*, 387 U.S. 905 (1967).

88. *Id.* at 623 (emphasis added). The court of appeals agreed, stating:

It is true that in terms of the financial worth of Sullivan's interest in the corporation, it was the same after the transaction as it was before. The transaction still

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from an obligation to purchase at fair market value does not, of course, economically benefit the purchaser any more than would a mutual agreement with the seller to cancel the contract.

To summarize, substance had become associated with benefit in stages. In *Old Colony*, payment of the employee's debt increased his net worth; and *because* the payment benefited him, it was considered as constructively made to him. In *Wall*, where payment of the shareholder's debt did *not* increase his net worth, the payment was considered as constructively made to him. By *Sullivan*, however, payment of an executory obligation which, as in *Wall*, did *not* increase net worth, was considered as benefiting the shareholder *because* it was constructively made to him. The logical fallacy of that conclusion resembles the reasoning that because all dogs are four-legged animals, all four-legged animals are dogs. In fact, because payments which increase someone's net worth are considered made to him does not mean that constructive payments to him increase his net worth. The question for dividend purposes is not whether the distribution increases the net worth of a shareholder: no dividend is an economic benefit to him. Rather, the question is whether the transfer of corporate funds can be considered to satisfy his debt and therefore to constitute a distribution to him under *Wall*. As discussed in the following section, the answer to that question turns not on the purported substance or benefit of a dividend, but on the substance of negotiations.

D. *Why Court Holding Reconciles the Cases: Substance As Negotiation*

Because both the district court and the court of appeals in *Sullivan* were looking for the substance of a dividend, they were unable to analyze why satisfaction of a shareholder's executory obligation—which is not an indebtedness—should come within the discharge of indebtedness principle of *Wall*. Indeed, the taxpayers in *Sullivan* attempted to distinguish a contractual obligation to purchase stock from payment of already-incurred indebtedness. To this the district court replied that “[n]o authority has been found which will support this not wholly clear contention.”⁸⁹ But the district court could not—or at

resulted in an economic benefit to Sullivan, however, because he was relieved of his personal obligation to purchase Nelson's stock.

363 F.2d at 729 (footnote omitted).

89. 244 F. Supp. at 617. The court treated as a separate argument the contention that the obligation was “executory,” misconstruing the word to mean that an obligation is executory until it is unconditional. In fact, the single argument is that an executory purchase obligation, even if unconditional, is not yet an indebtedness.

any rate did not—explain why the three decisions on which it primarily relied would support a conclusion that redemption of stock which a remaining shareholder “was unconditionally and primarily obligated to purchase”⁹⁰ constituted a dividend to him. Two of those decisions, *Wall* and *Woodworth v. Commissioner*,⁹¹ concerned payment of indebtedness; the third, *Holsey v. Commissioner*,⁹² did not involve an unconditional obligation.

Despite the lack of explanation in *Sullivan*, that case is the only authority cited by the Service in *Revenue Ruling 69-608* to support taxability on the basis of a primary and unconditional executory obligation to purchase.⁹³ However, when a corporation pays a debt incurred by a shareholder, as in *Wall*, the shareholder has already received the money, stock, or other property for which the debt was incurred. The corporation's payment of that debt, which increases the amount of the shareholder's beneficially owned assets outside corporate solution, can therefore be considered a distribution to him. By contrast, when a corporation satisfies a shareholder's executory obligation to purchase shares at fair market value, as in *Sullivan*, the shareholder who executed the contract has not yet actually received the stock which he has agreed to purchase. Since the amount of assets in corporate solution attributable to the purchasing shareholder's previously owned stock will not change, a distribution of assets to satisfy the shareholder's executory obligation to purchase additional stock increases the amount of his assets outside corporate solution only if it is assumed that he has owned *in* corporate solution an amount of assets attributable to the additional stock. Therefore, to fit *Sullivan* within the principle of *Wall*, stock that in *Wall* had actually been purchased prior to the redemption must by reason of the executory contract be treated as having been constructively purchased by the shareholder and then redeemed for payment of the purchase indebtedness.

Sullivan can be recast to fit the facts of *Wall* not because of any economic substance of dividends common to both cases, but because

90. *Id.* at 616.

91. 218 F.2d 719 (6th Cir. 1955).

92. 258 F.2d 865, 866 (3d Cir. 1958), discussed at pp. 877-78 *supra*. *Holsey* does state that the criterion of a dividend is whether the remaining shareholder has an unconditional obligation to purchase, 258 F.2d at 868, citing in support of this proposition first *Wall*, then *Ferro v. Commissioner*, 242 F.2d 838 (3d Cir. 1957), and *Zipp v. Commissioner*, 259 F.2d 119 (6th Cir. 1958), *cert. denied*, 359 U.S. 934 (1959). *Ferro*, however, involved a release from an executed contract, while *Zipp* seems *sui generis*—involving the abandonment by a principal shareholder, in return for a distribution from the corporation, of certain conditions he had attached to the gift of shares to his sons.

93. 1969-2 C.B. 43, Situation 1. For a discussion of this ruling, see p. 878 *supra*.

of the principles of tax law applying to sales. The definitive expression of those principles is *Court Holding Co. v. Commissioner*,⁹⁴ which concerned negotiations by a corporation to sell its sole asset, an apartment building. After oral agreement (unenforceable at that point under the relevant state law) had been reached with the prospective purchasers, the selling corporation's attorney advised that the corporation could not consummate the sale because of the large tax that it would thereby incur. Very soon thereafter, the attorney met with the selling corporation's shareholders and directors, who took the procedural steps to liquidate the company and distribute the apartment building to the shareholders. A contract of sale on the same terms previously agreed to—but with the shareholders rather than the corporation as seller—was then executed and carried out.⁹⁵

The Supreme Court affirmed the Tax Court's conclusion that the building should be considered as having been sold by the corporation rather than its shareholders, stating that "[t]he incidence of taxation depends upon the substance of the transaction."⁹⁶ That statement cannot refer to economic substance—the terms of the sale—since apart from the anticipated tax consequence the identity of the seller was a matter of indifference to the parties. The statement refers instead to the substance which tax law accords negotiations as to the manner in which a transaction will occur. Had negotiations leading up to the same contract been conducted solely on behalf of the shareholders, they, rather than the corporation, would have been considered to have made the sale.⁹⁷

The "substance" to which *Court Holding* refers therefore does not prevent a taxpayer from casting a sale, including a bootstrap acquisition, in the form best designed to minimize tax. What the Court's

94. 324 U.S. 331 (1945), *rev'g* 143 F.2d 823 (5th Cir. 1944), *rev'g* 2 T.C. 531 (1943).

95. 2 T.C. at 532-36. The shareholders intended to avoid tax on gain at the corporate level. Gain at the shareholder level would be recognized regardless of whether the liquidating corporation distributed the building or sale proceeds. An effective distribution of the building, however, would have given the shareholders a cost basis for the property equal to its then fair market value, and therefore they would not have realized any gain upon its subsequent sale by them. By contrast, the corporation's cost basis for the building was low, and taxable gain was therefore recognized at the corporate (as well as at the shareholder) level by treating the corporation as having made the sale and distributed the proceeds.

96. 324 U.S. at 334.

97. See *United States v. Cumberland Pub. Serv. Co.*, 338 U.S. 451 (1950), in which similar tax considerations caused a corporation to reject an offer to purchase its assets. The shareholders of the corporation then offered to acquire the assets and sell them to the prospective buyer. This offer was accepted, the assets distributed in partial liquidation, and the sale consummated. Commenting that the distinction between that case and *Court Holding* was "shadowy and artificial," 338 U.S. at 454, the Supreme Court nevertheless affirmed a decision that in substance the sale had been made by shareholders.

use of the term does mean is that the form of distribution and sale selected must be consistent with the negotiations leading up to the transaction. The tax principles applicable to distributions in complete liquidation incident to a sale—the facts of *Court Holding*—are equally applicable to partial distributions incident to a bootstrap acquisition. A search for the economic substance of those distributions is fruitless; instead, a court must focus on “negotiation substance.” If the negotiations are consistent with the form of distribution and sale carried out by the parties, that form should determine the tax consequences.

The above approach provides a logically satisfying explanation of why *Sullivan* and *Wall* should reach the same tax result. *Sullivan* is the obverse of *Court Holding*. In *Court Holding*, a corporation which had negotiated and agreed to the sale was treated by the court as having made the sale and then transferred the cash consideration to its shareholders, although the shareholders actually carried out the sales contract. Application of that principle to *Sullivan* means that the shareholder who had negotiated and agreed to the stock purchase should be treated as having made the purchase and then transferred the consideration received (the stock) to the corporation, although the corporation actually satisfied the purchase contract. Had the shareholder in *Sullivan* actually made the purchase, he would have owed the seller money. Since under that construction the corporation would have satisfied a debt rather than an executory obligation, the facts are parallel to those in *Wall*.

Failure to articulate this underlying similarity of *Wall* and *Sullivan*, however, results in obscuring the concept of dividend as simply an increase in assets outside corporate solution. Upon that concept rests the ability to distinguish a situation in which such increase occurs with respect to the taxed shareholder—as in *Wall* and *Sullivan*—from one in which it does not, as in *Steel Improvement & Forge Co. v. Commissioner*.⁹⁸ The Sixth Circuit in *Steel Improvement* did not have a clear idea of what a dividend distribution is; for that very reason—as explained in the following section—its holding takes a step beyond *Wall* and *Sullivan* without realizing that it is doing so.

E. *The Conceptual Flaw of Steel Improvement: Dividends Without an Increase in Non-Corporate Assets*

Zenz, Kobacker, Sullivan, and Cromwell reached the correct results. However, their essentially meaningless reasoning—the concept of divi-

98. 314 F.2d 96 (6th Cir. 1963), *rev'd* 36 T.C. 265 (1961).

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dend distribution as a substantive event—raised the possibility that such a concept could be used to justify the wrong result. That possibility was realized in *Steel Improvement*. There the taxpayer, an American corporation, sold all the stock of its Canadian subsidiary. The buyer, in order to avoid a Canadian tax on distribution to it of the subsidiary's accumulated earnings,⁹⁹ negotiated to purchase a company without earnings. Accordingly, the sales contract provided that prior to closing the subsidiary could pay the taxpayer, its parent, a dividend of \$116,000.¹⁰⁰ The taxpayer was willing to receive the \$116,000 dividend because it expected to receive a foreign tax credit that would offset any United States tax on the distribution.

That belief turned out to be mistaken. After the sale, the buyer caused the subsidiary to make an election which resulted in a refund of the Canadian tax for which the taxpayer-seller had claimed a foreign tax credit. The American seller, faced with the possibility that loss of the credit for the refunded Canadian tax would result in additional American tax calculated at the ordinary income rate, then reversed the position taken on its return and claimed that the \$116,000 distribution constituted part of the purchase price it had received on the sale of its subsidiary and therefore was taxable to it at the lower capital gain rate. The Service convinced the Tax Court majority that the \$116,000 dividend declared and paid to the seller prior to closing the sale was the seller's dividend income:

[We agree with the Service] that it was the intention of the parties that the dividend be paid to [the seller]; that the dividend was not a part of the purchase price since the contract of sale permitted but did not require that a dividend be paid to the extent of [\$116,000, without] adjustment to the purchase price . . . ; that [seller] was in control of the corporation at the time the dividend was declared; . . . that the dividend was paid while [seller] was still owner of the stock; [and] that both the purchaser and [seller] planned the transaction as a dividend to [seller] in substance as well as in form¹⁰¹

99. Because the \$116,000 was characterized as "designated surplus" under Canadian law, its distribution to the Canadian buyer would not, unlike other Canadian intercorporate dividends, be offset by a 100% deduction. *See* 36 T.C. at 272-73.

100. The contract actually provided that a dividend of up to \$180,000 could be declared, but that a dividend of less than that amount would increase the purchase price, up to a maximum increase of \$64,000. *Id.* at 268. The effect of this provision was that the seller could extract up to \$116,000 from its subsidiary without affecting the buyer's maximum offer (his nominal offer plus \$64,000); the seller could further extract up to another \$64,000, but in doing so would reduce the price received from the buyer pro tanto. Only \$116,000, then, could have been considered a dividend from the subsidiary to the buyer.

101. 36 T.C. at 273-74.

That passage neatly summarizes the taxpayer's position in *Waterman*, a position which the Service opposed. Moreover, the Sixth Circuit's reversal of the Tax Court in *Steel Improvement* only compounds the effect of the Service's inconsistency, because when the Service was right (*Steel Improvement*) it lost;¹⁰² and when it was wrong (*Waterman*) it won.

In reversing the Tax Court, the Sixth Circuit reasoned that the substance of the transaction depended on the "beneficial ownership" of the stock at the time the distribution was made. Despite the Tax Court's findings, the court of appeals determined that the *buyer* was the beneficial owner of the stock at the time the \$116,000 distribution was made and that therefore the \$116,000 was a dividend to it, on the ground that it was then the "party who bears the operating risks of the business and stands to benefit from profits or suffer detriment from losses."¹⁰³ That formulation presents some difficulties.

First, if benefiting from profits were the proper criterion, it would be more appropriate to tax a distribution of accumulated profits to the seller, who economically benefited from the accumulation of *those* profits, rather than to the buyer, who will benefit only from accumulation of other profits. Had the profits of the distributing Canadian subsidiary in *Steel Improvement* been earned after 1962, § 1248 would prescribe that result regardless of whether the distribution were characterized as dividend or purchase price.¹⁰⁴

Second, the formulation assumes its conclusion. The buyer cannot beneficially own more by executory contract than he will own after the contract is executed. The question to be decided, not assumed, is what stock the buyer has contracted to purchase (the standard of *Revenue Ruling 69-608*) or negotiated to purchase (the standard of *Court Holding*):¹⁰⁵ stock of a corporation which does not include the

102. As *Steel Improvement* was framed by the parties and the court, the Service was right. However, neither the parties nor the court took into account the source of the funds used to pay the dividend. The \$116,000 received by the seller may have been indirectly supplied by the buyer, with the subsidiary acting as a conduit for part of the purchase price. See note 139 *infra*. The Service's attempt to tax the \$116,000 as a dividend to the seller would then have been incorrect.

103. 314 F.2d at 98. Had the court confronted its earlier *pacan* to form in *Woodworth v. Commissioner*, 218 F.2d 719 (6th Cir. 1955) (quoted at p. 875 *supra*), it might have had more difficulty in deciding as it did.

104. See p. 871 *supra*.

105. Because Rev. Rul. 69-608, 69-2 C.B. 43 (discussed at p. 878), relies on *Sullivan*, its determination of the stage at which agreement substantively determines tax result differs from that of *Court Holding*. Whereas *Court Holding* would treat as seller the person who negotiates the sale, Rev. Rul. 69-608 treats a remaining shareholder as the purchaser of redeemed shares only if he has a "primary and unconditional obligation" under the *contract*. The difference, then, is whether one looks to the negotiations or the contract to determine what agreement should be given effect.

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distributed profits, or stock of one which does. The answer to that question depends on substance, but as previously indicated it is the substance of intent, not of distributions. The Tax Court saw this, and its holding that the *Steel Improvement* dividend was taxable to the seller cited *T.J. Coffey, Jr.*¹⁰⁶ In *Coffey*, the buyer did not want to acquire the corporation with a particular asset, called the Cabot payment, which was accordingly distributed to the seller before closing. The Tax Court decided the dividend was that of the seller, stating:

The purchasers did not agree to buy their stock and then turn over to them \$190,000 and the Cabot payment in consideration therefor. From the testimony . . . it is apparent that they were not interested in the Cabot payment, did not want it included in the assets of the corporation at the time they acquired its stock, and negotiated with the [sellers] to acquire stock of a corporation whose assets did not include the unwanted Cabot payment.¹⁰⁷

In like manner, for tax rather than business reasons the buyers in *Steel Improvement* and *Zenz* intended to acquire stock of a corporation without accumulated profits; but only in *Steel Improvement* did the Sixth Circuit feel that "substance" should defeat such intention.¹⁰⁸

The third essential difficulty with the Sixth Circuit's beneficial ownership test is that since the distribution did not increase the buyer's noncorporate assets, either actually or constructively under *Court Holding*, the concept of dividend on which the result rests has no coherence. The court likened the buyer's situation to that of the buyer in *Moore v. Commissioner*¹⁰⁹ and *Frithiof T. Christensen*,¹¹⁰ both of which held that a dividend paid to the seller was income to the buyer. In those cases, however, the distribution was made after the sale had occurred, and the seller held legal title to the stock only as security for the unpaid purchase debt.¹¹¹ The fact pattern in those

106. 14 T.C. 1410 (1950).

107. *Id.* at 1417, quoted in *Steel Improvement*, 36 T.C. at 275.

108. *Zenz* does not specifically discuss taxation of the buyer, but *Woodworth v. Commissioner*, 218 F.2d 719 (6th Cir. 1955), indicates that the *Zenz* form does not cause him to be taxed. 36 T.C. at 274. The difference in result (between *Zenz* as interpreted by *Woodworth* on the one hand, and *Steel Improvement* on the other) cannot be justified by the surrender of stock in *Zenz*. Whereas the buyer in *Zenz*, at the time of the distribution to the seller, actually owned his stock, the buyer in *Steel Improvement* had only a lesser, beneficial ownership. If substance requires the inclusion of a distribution to a seller in a buyer's income when that buyer has a beneficial ownership of the stock, it should also require inclusion when the buyer actually owns his stock; yet the Sixth Circuit rejected this very conclusion in *Woodworth*.

109. 124 F.2d 991 (7th Cir. 1941).

110. 33 T.C. 500 (1959).

111. The Sixth Circuit also found applicable *Miller v. Commissioner*, 247 F.2d 206 (7th Cir. 1957), in which the dividend was declared while the purchase contract was

cases thus is basically parallel to that of *Wall*. *Steel Improvement's* is not, however, since the distribution did not actually satisfy any indebtedness of the buyer, nor can it be so recast. For example, if the prospective buyer of a corporation having \$1,000 of equity negotiates only to acquire stock of a corporation having \$600 of equity, he cannot be considered to have acquired a \$1,000 corporation. He therefore cannot be considered to have incurred a \$400 indebtedness in order to buy the \$1,000 corporation; and if he cannot, a \$400 distribution to the seller, unlike the *Wall* situation, in no way satisfies his debt.

In *Steel Improvement*, the Sixth Circuit found its conclusion

particularly appropriate under the facts of the present case, wherein it clearly appears from the record of the negotiations that the parties considered the \$116,000 at issue to be part of the purchase price. In those negotiations [the seller] said it must realize \$900,000 The fact that [\$116,000] was in the technical form of a dividend does not alter the fact that it constituted a portion of the \$900,000 purchase price arrived at by negotiation.¹¹²

The buyer, however, appears to have been aware at all times that acquisition of the corporation's undistributed income would cause it a Canadian tax problem, and to have negotiated only on the basis that the transaction occur in the form it did.¹¹³ The seller, who expected a foreign tax credit, also negotiated on the basis that the distribution would be taxed to it as a dividend. Under those circumstances, *Court Holding* does not justify constructing an obligation of the buyer which was satisfied by the distribution. On the contrary, by permitting but not requiring a distribution to the seller, the parties went out of their way to *avoid* having the distribution satisfy such an obligation.

F. *The Effect of Steel Improvement and Waterman*

*Casner v. Commissioner*¹¹⁴ shows how *Steel Improvement* and *Waterman* may continue to affect both reasoning and result. In that case Casner, principal shareholder of a corporation which had been granted

executory. However, in *Miller*, the dividend was used to reduce the purchase price stated in the contract; in that situation the principle of *Court Holding*, see p. 883 *supra*, treats the buyer as if he had completed the purchase.

112. 314 F.2d at 98.

113. At a very early stage the buyer examined the corporation's financial statements to determine its undistributed income, and the first concrete offer made by the buyer required a distribution to the seller. See 36 T.C. at 267.

114. 450 F.2d 379 (5th Cir. 1971), *aff'g in part and rev'g in part* 28 CCH Tax Ct. Mem. 535 (1969).

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a Chevrolet dealership, agreed at the urging of General Motors Corporation to terminate his participation in the company.¹¹⁵ General Motors required that shares in its distributorship companies be sold at book value. In order to reduce book value so that the purchasers could acquire Casner's shares at a smaller out-of-pocket cost while satisfying Casner's insistence that he receive as much cash as possible, the corporation declared and later distributed a pro rata dividend to the corporation's six shareholders.

Contemporaneous with the declaration, Casner and another shareholder, Slight, agreed to sell all their stock in the distributing company; two other shareholders used their distributions to buy part of Casner's stock;¹¹⁶ and the remaining two, whose holdings were small, did not buy or sell. Neither buyers nor sellers reported any distribution as dividend income. Casner and Slight claimed that the distributions to them represented part of the purchase price for their shares; the buyers, on the other hand, argued that even distributions to themselves were income of the sellers.

Agreeing with the Service's position, the Tax Court held that form governed and that the distributions were taxable as dividends to the respective recipients. With respect to the distributions received by the sellers, Casner and Slight, it distinguished the Sixth Circuit's *Steel Improvement* decision on three grounds: first, that four of the six recipients did not sell any shares; second, that the *Casner* distributions were not intended to be included as part of the purchase price;¹¹⁷ and finally, that beneficial ownership remained with the original owners at the time the dividends were declared, because minutes of the directors' meetings at which the declaration of the distribution was made specifically stated that the sellers' transfers of stock would not be effective until a few days later.

The distinction that most of the recipients were not selling shares

115. For ease of illustration, the distributions will be discussed as if made by a single company, although they actually came from two corporations. Stock owned by the same family group will be discussed as if owned directly by one individual.

116. Casner also gave some of his stock to one of the purchasers, his son-in-law; his remaining stock, as well as Slight's, was sold to new shareholders. 450 F.2d at 382.

117. 28 CCH Tax Ct. Mem. at 541. On appeal, the Fifth Circuit found as a fact—contrary to the Tax Court's statement as to the intentions of the parties—that the sales price for the stock “was fixed at book value *including paid-in capital surplus*.” 450 F.2d at 394. In fact, however, the minutes of the relevant board of directors meeting, as cited by the Tax Court, indicate that the agreed-on sales price was exclusive of the paid-in capital surplus and that this surplus was to be distributed as the dividend at issue in the case. 28 CCH Tax Ct. Mem. at 539.

In any event, the Fifth Circuit did not decide the case on the basis of its finding. Had it done so, it would have been returning to the criterion of intent used by the Tax Court in *Waterman* and *Steel Improvement*. See pp. 869, 885 *supra*.

is persuasive, since it is difficult to conclude that some pro rata distributions made pursuant to a single dividend declaration should be characterized as purchase price to shareholders selling their shares, whereas others should not. The second and third grounds, however, do not distinguish *Steel Improvement*, but rather are restatements of the positions that the Sixth Circuit's *Steel Improvement* opinion specifically rejected. It was the Tax Court in *Steel Improvement* that used the criterion of intention; a principal point of the Sixth Circuit's reversal was that its notions of economic substance prevailed over intention. In like manner, the Tax Court in *Casner* assumed that the sellers' beneficial ownership continues until the stock is transferred. But the buyer's rights *before* transfer are exactly what the Sixth Circuit in *Steel Improvement* intended beneficial ownership to mean. Indeed, it was to support such a meaning that the decision blurred the distinction between use of the term by *Moore* and *Christensen* (which referred to the buyer's ownership of stock subject to the seller's security interest for the remaining unpaid purchase price)¹¹⁸ and its own definition as the buyer's rights under an executory contract (where the transfer had not yet occurred).

Misinterpreting *Steel Improvement*'s definition of "beneficial ownership" thus allowed the Tax Court to decide *Casner* in accordance with the *Wall* principle that only distributions which satisfy an obligation of the buyer are income to him. Similarly, disregarding *Steel Improvement*'s rejection of intent as a criterion allowed the Tax Court to fit its decision within the *Court Holding* principle, since the buyer never intended to buy a corporation which owned the distributed profits. Although the principles of *Wall* and *Court Holding* should have determined to whom the distribution in *Casner* was a dividend, they do not serve to distinguish *Steel Improvement*, the reasoning of which specifically rejects intent in favor of a purported substance.

With respect to distributions received by the buyers, it was argued that they did not receive a dividend because of their obligation to turn over the actual checks to the sellers. The Tax Court decided that the buyers were taxable because they used their dividends to purchase stock, adding that "[c]ertainly, they realized an economic benefit."¹¹⁹

Reversing in part, the Fifth Circuit held that distributions to both the sellers and the buyers were includable in the income of the buyers. Quoting extensively from the appellate court opinions in *Steel Improvement* and *Waterman* and liberally citing cases involving tax

118. See p. 887 *supra*.

119. 28 CCH Tax Ct. Mem. at 542.

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avoidance, the court chided the Commissioner for his inconsistency in seeking to give dividend treatment to the sellers in *Casner* but not in *Waterman*:

Seemingly, this inconsistency between the Commissioner's position in this case and his position in *Waterman Steamship Corporation* evidences a tendency to rely on "substance" when beneficial to the revenues or to rely on "form" when more beneficial to the revenues. In any event, this approach cannot be accepted. The economic substance of a transaction should generally be decisive of its tax consequences to the taxpayer.¹²⁰

The criticism is deserved. It should, however, have been made earlier, when the Commissioner abandoned his correct *Steel Improvement* position in litigating *Waterman*. The inconsistency which *Casner* criticizes is just a return to the Government's view in *Steel Improvement*, a return made in circumstances which indicate that benefit to the revenues was not the primary motive. The Service probably drew back from *Waterman* because of concern that its result (a distribution to a seller treated as purchase price received by him) would, as in *Casner*, cause an unexpected dividend consequence to the buyer¹²¹ and a windfall to a seller other than a corporation.

The tax avoidance reasoning of *Casner* is even more difficult to comprehend than that in *Waterman*. First, the desired tax result could have been achieved through *Zenz*, and hence the court ignored the principle that tax avoidance should not be found where another form produces the same result. Second, and more important, in *Casner* the decision that distributions to the sellers were includible in the buyers' income resulted in a wholly unexpected tax to the latter. This consequence would not have occurred in *Steel Improvement*, where the buyer was a foreign corporation (which in any event was not before the court) and thus not subject to United States tax on the Canadian distribution.¹²²

120. 450 F.2d at 398.

121. See p. 872 *supra*.

122. Recasting the form of a bootstrap acquisition is particularly objectionable where it unexpectedly reallocates the tax burden. In *Casner*, the seller was apparently in a high enough bracket that his tax would be significantly increased by the receipt of a dividend rather than capital gain; yet he agreed to receive a dividend. If the purchase price was adjusted to reflect that tax detriment, inclusion of the dividend in the buyer's income produced a capital gain windfall to the seller. The issue was cogently expressed (although from the perspective of the buyer rather than the seller) in *Commissioner v. Danielson*, 378 F.2d 771, 775 (3d Cir. 1967): an attack based on substance "would nullify the reasonably predictable tax consequences of the agreement to the other party thereto. . . . If unsuccessful, the buyer would lose a tax advantage it had paid the selling-taxpayers to acquire."

Finally, as might be expected, *Casner* spoke in terms not only of tax avoidance, but also of economic benefit. The decision noted that the cash distributions to the sellers reduced the book value of the stock purchased, and concluded that "[c]ertainly, such reduction . . . represented a true economic benefit received by the *buying stockholders*, [thereby resulting] in the constructive receipt of taxable dividends by the buying stockholders."¹²³ Yet shortly thereafter, the court rejected an argument that the distributions received directly by the buyers were not taxable to them "because they received no economic benefit from the cash distributions."¹²⁴ In a succinct, logical statement of what a dividend is—which it did not apply elsewhere in *Casner* or in *Waterman*—the Fifth Circuit said:

[W]e conclude that the buying stockholders received the same benefit from the cash distributions as would any other recipient of a dividend distribution. To suggest that the proper test is whether the shareholders are better off economically after the cash distributions than before is incorrect since no dividend distribution enlarges the net worth of the shareholders. A dividend merely transfers part of the value represented by the [shareholder's] ownership interest in the corporation out of corporate solution and into his personal possession, reducing the value of his corporate interest by the same amount received by him and thus leaving his over-all net worth unchanged.¹²⁵

The *Casner* reasoning, then, had become so loose as to render the language employed meaningless. To summarize the contradictions:

1. The Tax Court in *Casner* used the term beneficial ownership to mean something different than what the Sixth Circuit meant by its use of the term in *Steel Improvement*.

2. The Tax Court stated that the buyers "certainly" realized an economic benefit from the distributions directly to them, whereas the Fifth Circuit suggested that any such "benefit" was not economic.

3. In the most flagrant of the contradictions, the Fifth Circuit stated that the distribution to the sellers was an "economic benefit" to the buyers but indicated that the distribution directly to the buyers was taxable to them even though not an "economic benefit" to them. In other words, a distribution to *Y* economically benefits *X*, whereas a distribution to *X* himself does not.

The potential for further inconsistency is obvious. As a consequence of the *Casner* decision, the Tax Court has implied that the *Zenz* form

123. 450 F.2d at 399 (emphasis added).

124. *Id.* at 400.

125. *Id.*

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might also result in a dividend to the buyer.¹²⁶ On the other hand, the Service, which has stated that it will not follow *Casner*,¹²⁷ held in *Revenue Ruling 75-447*¹²⁸ that redemption of the seller's stock was to be treated as a distribution to him; as such, it could not be a dividend to the buyer.

The Service's opposition to *Casner* itself contains discrepancies. In implicit response to the charge of inconsistency made by *Casner*,¹²⁹ the ruling which reaffirmed the Service's position in that case—*Revenue Ruling 75-493*—distinguished *Waterman* by stating:

Because the funds to pay the dividend [to *Waterman*] were actually furnished by the buyer, that amount was considered as part of the purchase price paid by the buyer for the stock of the subsidiary. Thus, the form of the transaction was a sham designed to disguise the true substance of the transaction.¹³⁰

By contrast, when the buyer furnishes funds for distribution to the seller in *redemption* of part of the seller's shares, the Service analyzes the transaction differently. In Situation 1 of *Revenue Ruling 75-447*, two individuals *A* and *B* owned all the stock of a corporation, caused it to issue 25 new shares to a third individual *C*, and "as part of the

126. *Royal Arrow Co.*, 31 CCH Tax Ct. Mem. 241, 246 n.3 (1972).

127. Rev. Rul. 75-493, 1975 INT. REV. BULL. No. 46, at 8.

128. 1975 INT. REV. BULL. No. 42, at 9.

129. See p. 891 *supra*.

130. 1975 INT. REV. BULL. No. 46, at 8. As of this writing, however, the Service had argued—in a case tentatively decided after issuance of Rev. Rul. 75-493—that the *Waterman* result obtained even where the buyer had not furnished funds with which to make the distribution. In *Basic, Inc. v. United States*, 76-1 U.S. Tax Cas. ¶ 9126 (Ct. Cl. 1975) (trial judge's recommended opinion), the taxpayer-seller (Inc.) owned all the stock of Falls Industries Incorporated (Falls), which in turn owned all the stock of Basic Carbon Corporation (Carbon).

An unrelated corporation offered to purchase the businesses of Falls and Carbon. After considering the tax consequences, Inc. agreed to sell only the stock of both Falls and Carbon. In order to take advantage of Falls's basis in Carbon stock, Inc. caused Falls to distribute its Carbon stock to Inc. just prior to the sale. A dividend of Carbon stock from Falls to Inc. would not reduce Inc.'s tax basis in the stock of Falls. It would, however, give Inc. a basis in the Carbon stock equal to the amount of Falls's basis in Carbon. § 301(d)(2)(B). Thus, although the amount of the distribution (that is, the amount of Falls's basis in Carbon) would be taxed to Inc. at the low rate applicable to intercorporate dividends, that same amount would—by giving Inc. a basis in the stock of its former second tier subsidiary—decrease income subject to the higher rate of capital gains tax.

The trial judge held that Inc. "has not shown that there was a reason for the transfer of the Carbon stock from Falls to [Inc.] aside from the tax consequences." 76-1 U.S. Tax Cas. ¶ 9126, at 83,089. He therefore refused to recognize that a dividend had occurred for tax purposes, stating that such treatment "is in keeping with the results reached in like situations" (citing *Waterman*). *Id.* Under its position in Rev. Rul. 75-493, however—which undoubtedly was issued after the arguments and briefs in *Basic*—the Service should not have argued that *Waterman* requires the trial judge's result; the buyer in *Basic* did not furnish the Carbon stock that was distributed.

same plan" had the corporation redeem 50 shares of their stock. *G*, the buyer, therefore furnished one-half the funds used to make the redemption. Nevertheless, the ruling characterized the entire amount received by *A* and *B* as "distributed" to them in redemption of their stock. Thus, where the buyer furnishes funds to the corporation, the Service's position is that "true substance"—and taxation of a dividend to the *buyer*—rests on whether the distribution to the seller is accompanied by an economically meaningless surrender of stock.

A second discrepancy in the Service's position concerns the importance which it accords to timing when a distribution to a seller is declared as a dividend but not when a distribution is made in redemption of stock. The Service's disagreement with *Casner* is illustrated by the holding of *Revenue Ruling 75-493* that a cash dividend formally declared and paid to the seller prior to his signing the sales contract was taxable to him. The ruling emphasized that at the time of declaration and payment the buyer "was under no legal obligation" to purchase the stock although—since the seller had offered to cause the dividend "with the understanding that [the purchaser] would then buy the [corporation's] stock"—the purchase agreement signed the next day was clearly contemplated by both parties.¹³¹ With respect to a redemption, however, *Revenue Ruling 75-447* states that where the distribution and purchase "are clearly part of an integrated plan . . . , the sequence in which the events occur will be disregarded."¹³² Based on *Zenz*, this result is an administrative recognition of the holding of that case as one of substance, which "requires that effect be given only to the overall result and proscribes the fragmenting of the whole transaction into its component parts."¹³³ Again, as in the situation where a buyer furnishes funds, the Service's perception of substance rests on form, since the proscription against fragmenting the transaction applies only when stock is surrendered.

131. 1975 INT. REV. BULL. No. 46, at 8. Somewhat inexplicably, the ruling mentions that in *Waterman* the seller sold the stock "one hour" after the distribution, as though the 23-hour difference mattered in determining whether the distribution should be integrated with the sale. A factor not mentioned, but which should be relevant in deciding if two steps should be integrated, is whether the first step is reversible without substantial adverse consequences. In Rev. Rul. 75-493 the seller was stated to be an individual, so that repayment of the dividend if the sale fell through would nevertheless leave him with a tax by reason of the distribution. By contrast, in *Waterman* the distribution would have been eliminated from income as an intercompany dividend in a consolidated return year; and if the sale had not been effected, a contribution to capital of the distributing company would put the parties in the same position as if the distribution had never occurred. *Waterman's* ability to undertake the first transaction without tax or other cost means that, in assessing the independence of the two transactions, less weight should be accorded the fact that the first one was effected before occurrence of the second one became certain.

132. 1975 INT. REV. BULL. No. 42, at 9, 10.

133. *Id.*

G. Towards Coherence

The above discussion suggests some conclusions about the economic substance of dividends as perceived by *Waterman*, *Steel Improvement*, and the Service. First, despite the constant talk of substance and the search for economic benefit, form can permit a seller to achieve capital gain rather than a dividend (*Zenz*); and substance should therefore not prevent a seller from achieving a dividend rather than capital gain. Similarly, since form permits a buyer to eliminate a dividend from income through the use of consolidated returns (*Cromwell*), substance should not prevent a seller from doing so.

Next, the Sixth Circuit's perception of substance in *Steel Improvement* does not contain any coherent concept of dividend. Its talk of beneficial ownership, like talk of economic benefit, impedes seeing a dividend for what it is—a removal of assets from corporate solution. Determining the person whose assets are increased by such removal rests on the substance of negotiation or—as permitted by *Revenue Ruling 69-608*—contract.¹³⁴ As in *Court Holding*, the relevant negotiations will be determined by taxes rather than economics—not how much the seller will be paid, but in what form the transaction will occur. To illustrate, assume that, as in our earlier example,¹³⁵ a corporation has an equity of \$1,000 and \$400 is distributed. The question is whether the buyer has agreed to pay \$1,000 for a corporation worth \$1,000 (in which event the \$400 distribution should be considered as made to him), or \$600 for a corporation worth \$600 (with the \$400 considered as distributed to the seller).

The Service's position in *Steel Improvement*—that whether a distribution to the seller constitutes a dividend or purchase price is determined by the intent of the parties—does contain a coherent concept of dividend. Moreover, the Service could have challenged the taxpayer's dividend claim in *Waterman* on a ground consonant with both its *Steel Improvement* position and its rulings in the reorganization area. Whether amounts which in form are distributed by a transferred corporation prior to the sale or exchange of its stock in substance constitute purchase price furnished by the buyer should not depend upon whether the transaction is taxable. Section 368(a)(1)(B) requires that consideration received from the acquiring corporation in a stock-for-stock exchange consist “solely” of its voting stock.¹³⁶ To prevent avoidance of that requirement, the Service has

134. See note 105 *supra*.

135. Pp. 867, 887-88 *supra*.

136. If the exchange does qualify as a reorganization within the meaning of § 368(a)(1)(B), a transferor shareholder does not recognize gain or loss. § 354.

taken the position that funds distributed by the transferred corporation to its shareholders in the form of a dividend prior to the exchange will, if replaced by the acquiring corporation, be considered as consideration other than stock. That characterization, which treats the transferred corporation as a conduit, means that the exchange will not qualify as a reorganization.¹³⁷ Thus, the Service might have litigated *Waterman* solely on the basis that, as in a reorganization, distributed funds arranged for by the buyer and replaced by him after the acquisition should be treated as coming from him directly. Under that reasoning, disregard of the temporary note leads to the conclusion that the seller received cash from the buyer;¹³⁸ and disregard of both notes leads to the conclusion of Judge Tannenwald's Tax Court dissent that no dividend was distributed at all.¹³⁹ But the Service did not limit its argument to the ground that the buyer replaced the funds. It also maintained that the "substance" of the transaction in *Waterman* was a payment of purchase price to the seller "irrespective of the form of the transaction," relying on the Sixth Circuit's opinion in *Steel Improvement*.¹⁴⁰ Not only is this approach inconsistent with the Service's position that dividends distributed by the acquired company incident to a reorganization are not treated as purchase price if not arranged for by the acquiring corporation; more fundamental, it retreats to the view abandoned after *Zenz*, after *Kobacker*, and after

137. Conversely, property distributed by the transferred corporation, if not replaced by the acquiring corporation, is not treated as purchase consideration. Rev. Rul. 70-172, 1970-1 C.B. 77 (distribution of property immediately before the reorganization exchange not "part of the consideration given by [the acquiring corporation] in connection with the exchange of stock"); Rev. Rul. 68-435, 1968-2 C.B. 155 (same); Rev. Rul. 69-443, 1969-2 C.B. 54 (distribution immediately after acquisition to shareholders who were of record in transferred corporation immediately prior to closing). The Service failed to challenge a purported reorganization under § 368(a)(1)(B) in *Arthur D. McDonald*, 52 T.C. 82 (1969), where the acquiring corporation indirectly made funds available to the acquired corporation, which then used the funds to redeem its preferred stock just prior to the exchange. Because of the failure to challenge qualification of the exchange as a reorganization, the Service has indicated its disagreement with the result in that case. Rev. Rul. 75-360, 1975 INT. REV. BULL. No. 37, at 11.

138. Disregard of only the temporary note to the seller means that the buyer, if he purported to loan the distributed cash to the company in exchange for the note he received, must be considered to have received the note as a dividend. See p. 872 *supra*.

139. The question of whether in substance the corporation had made a distribution was not raised in *Steel Improvement*, although the seller received a cash dividend only because the buyer made arrangements with a bank to loan the acquired corporation the necessary funds. See 36 T.C. at 269.

140. 430 F.2d at 1191-92. Somewhat lamely, the Service stated that the diametrically opposed Tax Court opinion in *Steel Improvement* was not in conflict with its position.

The Fifth Circuit's failure in *Waterman* to take into account the \$2,799,820 diminution in Pan-Atlantic's net worth—as a result of that company's distribution of a note for that amount—makes unpersuasive its distinction of the facts of *Steel Improvement* as a case in which the distribution was "concededly" a dividend. *Id.* at 1195.

Cromwell—that taxation of distributions incident to an acquisition is governed by a search for economic substance.

Prodded by the *Casner* court's criticism and a realization that *Casner* could result in an unwarranted transfer of tax liability to purchasers, the Service has moved in *Revenue Ruling 75-493*¹⁴¹ to limit to two situations characterization of a dividend paid to the seller as, in substance, purchase price: first, where the buyer furnishes the distributed funds, as in *Waterman*; and second, where the dividend is paid after the signing of the purchase contract, as in *Steel Improvement*.

The first limitation conforms the Service's position in taxable acquisitions with that in reorganizations. Nevertheless, the Service's explanation of *Waterman* on that basis, like Judge Tannenwald's dissent, fails to discern that the note given by Pan-Atlantic to *Waterman* rather than the cash supplied by McLean and Securities was intended to be the dividend.¹⁴² The second limitation repudiates the rationale of *Waterman*, which relied on *Steel Improvement* but does not repudiate the rationale of *Steel Improvement* itself.¹⁴³ Moreover, the Service has concurrently *expanded* the scope of substance in redemptions so that timing—that is, form—no longer even binds the taxpayer.¹⁴⁴ But economic substance does not inhere in the niceties of contract signing and certificate cancellations: those are poor economic standards by which to determine for tax purposes whether a distribution incident to a bootstrap acquisition should be considered as independent

141. 1975 INT. REV. BULL. No. 46, at 8. See pp. 893-94 *supra*.

142. The conclusion of Rev. Rul. 75-493, 1975 INT. REV. BULL. No. 46, at 8, that "funds to pay the dividend were actually furnished by the buyer" is at odds with its assumption earlier in the same paragraph that "[o]ne subsidiary declared a dividend in the form of a promissory note to *Waterman*" (emphasis added). When a buyer indirectly furnishes funds to a seller by replacing those distributed by the corporation, the concept of dividend as a formal transfer most directly conflicts with the idea of a distribution as resulting in a diminution of assets in corporate solution. The conflict is easiest to resolve in favor of a finding that there was no distribution for tax purposes—and that the property came from the buyer—where the buyer replaces distributed cash by a contribution to capital. By contrast, when as in *Waterman* a note is distributed and the same or a similar note survives after the transaction as an obligation of the distributing company, it becomes more difficult to sustain the conclusion of Judge Tannenwald's Tax Court dissent that no distribution has occurred. That conclusion would be appropriate if the note were considered equity under tax principles governing shareholder debt, since the net corporate assets before and after the distribution would remain the same. If the note were a debt for tax purposes, however, net assets would be removed from corporate solution. Loaning the corporation funds to pay the debt does not replace them.

143. The Service may have reasoned that the criterion of a signed contract in Rev. Rul. 75-493 was the same as that of Rev. Rul. 69-608, 1969-2 C.B. 43, discussed at p. 878 *supra*. But whereas the later ruling can be explained by *Court Holding*, *Steel Improvement* cannot. Thus while the two rulings may seem to use similar standards, the case law on which they rely is inconsistent.

144. Compare note 64 *supra* with pp. 893-94 *supra*.

of or integrated with the sale on the basis of substance. If, as *Revenue Ruling 75-447* suggests,¹⁴⁵ a *redemption* distribution should be integrated with the sale, so that timing (and even the buyer's furnishing of funds) is irrelevant, logic requires a similar integration for such dividend distribution situations as *Casner* and *Kobacker*. Whether the substance of that integrated transaction is a dividend to the seller, as the Service claimed in *Zenz*; to the buyer, as the Service claimed in *Kobacker* and *Cromwell*; or to no one, as the Service conceded by following the result in all three cases, is no clearer now than it was when *Zenz* was decided more than 20 years ago. If, however, the taxation of distributions incident to a sale is determined not with regard to an alleged substance of dividend but rather with regard to a negotiation substance appropriate to sales, it becomes possible to apply a coherent dividend concept to *Zenz*, *Steel Improvement*, *Waterman*, and *Casner*: the recognition that form should control.

III. Transfers Between Commonly-Controlled Entities

In bootstrap acquisitions a corporation actually transfers property in respect of its stock. As the discussion in Part II has shown, the Service has frequently maintained that the characterization of this transfer as a dividend distribution cannot be determined by looking at its form alone: the circumstances surrounding the transfer must be examined for its underlying substance and for tax avoidance motives.

By contrast, when property is transferred without adequate consideration from a corporation to its commonly-owned affiliate, *Revenue Ruling 73-605* states that the Service automatically will characterize the event as a constructive dividend distribution to the common owner from the transferring company followed by his constructive contribution of the distributed property to the transferee:

An excessive payment made between controlled corporations results in a constructive dividend to the common owner followed by a capital contribution from the common owner to the corporation receiving the excess funds.¹⁴⁶

The Service's exclusive focus on the fact that property has been transferred from the solution of a particular corporation contrasts

145. See pp. 893-94 *supra*.

146. 1973-2 C.B. 109, citing Rev. Rul. 69-630, 1969-2 C.B. 112, and Sparks Nugget, Inc., 29 CCH Tax Ct. Mem. 318 (1970), *aff'd*, 458 F.2d 631 (9th Cir. 1972), *cert. denied*, 410 U.S. 928 (1973). Cf. Rev. Rul. 73-528, 1973-2 C.B. 13 (involving a transfer of funds between pension plans of the same employer).

sharply with its search in bootstrap acquisitions for the substance of such a transfer. It is therefore unfortunate but ironically fitting that courts which the Service asks to look for the substance of bootstrap acquisitions are equally willing to seek substance in the circumstances surrounding an intercompany transfer. Nor is it surprising that such substance is often expressed both in terms of tax avoidance and—even in the ruling just quoted—in terms of economic benefit to the common shareholder.¹⁴⁷ Difficult as it was to find a consistent meaning of “economic benefit” in the bootstrap acquisition cases, however, it becomes even more difficult to determine what courts mean when, in the context of intercompany transfers, they distinguish between “direct” and “derivative” benefit to the common shareholder.

A. PPG: *Dividends as a Function of Tax Avoidance*

In *PPG Industries, Inc.*,¹⁴⁸ the common shareholder was a United States corporation that owned all the stock of both a Brazilian holding company (Pittsburco) and a Swiss corporation (PPGI). Pittsburco, in turn, owned a minority interest in a Brazilian operating company (CVB) whose original cruzeiro tax cost to Pittsburco—computed for United States tax purposes at the dollar value of the cruzeiro when the investment was made—exceeded the stock’s value in 1961, the time of the transaction in question. Because of substantial depreciation of Brazilian currency against the dollar, however, Pittsburco’s *Brazilian* tax cost for its CVB shares—which was computed in cruzeiros—was less than its 1961 value in cruzeiros. Pittsburco therefore would have had to pay substantial Brazilian tax on a sale of its CVB shares for their fair market value, although in dollar terms it had lost money on its investment. Moreover, any cruzeiros received by Pittsburco upon such a sale would have been subject to Brazilian exchange control restrictions.

After a decision by Pittsburco not to invest any more capital in CVB, the Brazilian majority stockholders of CVB offered to purchase Pittsburco’s CVB shares outside Brazil. To mitigate the adverse Brazilian tax and exchange control consequences of such a sale, Pittsburco granted PPGI an option to purchase its CVB stock for 10% above its original cruzeiro cost. On the same day, PPGI purchased the shares and immediately resold them to the Brazilian group at a profit of more than \$477,000.

147. “A distribution by a corporation to a third party for the benefit of a shareholder is a constructive dividend, which will be taxed as a dividend to the shareholder for whose benefit the distribution is made.” Rev. Rul. 73-605, 1973-2 C.B. 109.

148. 55 T.C. 928 (1970).

The Service argued that the transaction amounted to a transfer of \$456,000¹⁴⁹ from one subsidiary to another which resulted in a constructive dividend of that amount to the common shareholder.¹⁵⁰ The court rejected that argument, stating:

[W]e do not believe that the purported transfer of the net sales proceeds in the amount of \$477,398.37 from petitioner's Brazilian subsidiary to its Swiss subsidiary *for demonstrable business reasons* resulted in a constructive dividend taxable to petitioner.¹⁵¹

The court gave two principal reasons for that conclusion. First, it referred to its prior decision in *Columbian Rope Co.*,¹⁵² which held that sales profits diverted from a Philippine to a Panama subsidiary in order to avoid exchange control restrictions were not includable in the income of the common shareholder, a United States corporation. Second, the court found that since the transaction neither discharged an obligation of the common shareholder nor was a "device for siphoning off corporate profits," it did not result in "any direct benefit" to the common shareholder.

The Tax Court in *Columbian Rope* initially stated the issue for decision as "whether [the Service] was correct in including the undistributed *income* of [the Panama company] in the taxable income of *petitioners*."¹⁵³ The following passage from *Columbian Rope*, quoted in *PPG*, also reads as though the Service contended in *Columbian Rope* that the sales *profit* of the Panamanian subsidiary was the amount that it proposed to include in the income of the United States shareholder:

If [the Panama subsidiary] had not been formed and, instead, all of the proceeds from the world sales of fiber were remitted directly to the Philippine subsidiary, it is clear . . . that its *profits* would not be includable in petitioner's taxable income until they were actually distributed to the petitioner. We do not see how the presence of [the Panama subsidiary] calls for any dif-

149. There is an unexplained discrepancy between the \$477,398 excess price that the Service asserted was received and the \$455,959 constructive dividend determined by the Service. *Id.* at 1000 n.11.

150. Alternatively, the Service contended that, under *Court Holding*, Pittsburco should be considered to have made the ultimate sale and transferred \$456,000 of the proceeds to PPGI, or that Pittsburco transferred \$456,000 of CVB stock to PPGI without consideration. Under the first alternative the constructive dividend would have been in cash; under the second, in kind. The court rejected both variants of this theory on the same ground as it did the theory presented in the text, and the discussion therefore applies to both theories. *See id.* at 1003.

151. *Id.* at 1002 (emphasis added, footnote omitted).

152. 42 T.C. 800 (1964).

153. *Id.* at 811 (emphasis added).

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ferent result. Nothing is changed: the income is still generated by the same fiber sales by the Philippine subsidiary on the world market, except that now some of the *income*, instead of returning to the Philippines, comes to rest in Panama.¹⁵⁴

Constructive dividends, however, arise not from a diversion of income, but from a diversion of property. Income is a *characterization* which tax law attributes to certain transfers of property. In a constructive dividend case, the distribution which is constructed is that of the property transferred, not of any tax characterization. The case best illustrating the distinction is *Helvering v. Horst*,¹⁵⁵ which has been used to support findings of a constructive dividend on grounds similar to that set forth in *Columbian Rope*.¹⁵⁶ In *Horst*, a father was held taxable on income arising from interest coupons which he removed from a bond and gave to his son shortly before they became payable. Clearly, the father had transferred *property* to his son; but tax law characterized as the father's *income* the amounts collected by the son when the coupons matured. Income, then, was the tax attribute of the transferred property, not the property itself. An attempt to divert a tax attribute from one company to its lower-taxed affiliate, or from a father to his lower-taxed son, may require a concomitant transfer of property. For example, if corporation or father X wants to show that affiliate or son Y is properly taxable on \$20 of income, Y must receive the \$20. But the same transfer of property can occur simply by X giving \$20 to Y without trying to allocate income artificially. Such a transfer, in the corporate context, is a dividend, because a dividend is the removal, not of tax attributes, but of *property* from corporate solution. The distribution of property from corporate solution may accompany, but does not *consist of*, the attempted assignment of income from the person to whom tax law attributes it.

The proper analogy to draw between an intercompany transfer and *Horst*, therefore, is not the income tax result of *Horst* but the uncontested gift tax consequences. Just as Mr. Horst would be considered to have made a transfer for gift tax purposes whether he gave his son \$20 of interest coupons or \$20 of bond principal, an intercompany transfer of property should be characterized as a constructive dividend regardless of whether the transferred property represents \$20 of sales profits or \$20 of contributed capital.

154. *Id.* at 812-13, quoted in 55 T.C. at 1002 (emphasis added).

155. 311 U.S. 112 (1940).

156. See p. 908 and note 188 *infra*.

Had *Columbian Rope* recognized the distinction between diversion of income and transfer of property, the sales profits transferred by the Philippine company would have been treated as a dividend to its parent even though the gain was not income to the parent.¹⁵⁷ Thus, although the fact pattern and result of *Columbian Rope* are substantially identical to those of *PPG*, its reasoning is inapposite to the Service's *PPG* argument. The Service in *PPG* was not trying to tax the shareholder on any purported imputed income to Pittsburco, but rather on the \$455,000 of sales proceeds constructively distributed by Pittsburco.

With respect to its second reason—that the parent had not obtained “any direct benefit” from the intercompany transfer—the *PPG* opinion stated that “[a]ny benefit that could possibly accrue to petitioner, as a parent corporation, would be purely derivative in nature,”¹⁵⁸ citing *W.B. Rushing*.¹⁵⁹ *Rushing* concerned a transfer of money from one corporation (LCB), owned by a Mr. Rushing, to another (Briercroft), also owned by him, which transfer the Service contended was a constructive dividend. At the page cited in *PPG*, *Rushing* rejected that contention, relying on the line of acquisition cases from *Holsey* through *Niederkrome* and *Priester*¹⁶⁰ to support its conclusion that benefit to the shareholder was too “indirect.”¹⁶¹ However, in those cases the distribution did not increase the noncorporate assets of the shareholder the Service sought to tax. In *Rushing*, on the other hand, the transfer increased the amount of Mr. Rushing's assets outside the

157. The Service's notice of tax deficiency in *Columbian Rope* did characterize the diverted proceeds as “foreign dividend income.” 42 T.C. at 809. Consistent with that characterization, the Service argued that the Panama corporation should be treated as a conduit, and that the court should “attribute the earnings which were temporarily passing through [the Panama corporation] as actually having been received by the ultimate beneficiary,” the common shareholder. *Id.* at 813. Although that language confuses the allocation of income with the distribution of property (in this case, money), it is an argument that the diverted funds represent a dividend from the Philippine corporation. But it is not the constructive dividend argument advanced in *PPG*—that the funds should be considered as distributed first to the parent and then to the transferee subsidiary.

158. 55 T.C. at 1002-03.

159. 52 T.C. 888, 894 (1969). The *PPG* court added a secondary reference to *Commissioner v. Offutt*, 336 F.2d 483 (4th Cir. 1964), discussed at note 167 *infra*.

160. For a discussion of this line of cases, see pp. 877-78 *supra*. Although citing only *Priester*, the *Rushing* court referred to a page in that opinion discussing *Holsey* and *Niederkrome* and stated that its reasoning was supported by a line of cases. 52 T.C. at 894.

The court also relied upon the Service's acceptance of a line of cases finding no dividend in a corporation's payment of premiums on a policy insuring the life of a shareholder and intended to fund the redemption of his stock upon death. *Id.*, citing Rev. Rul. 59-184, 1959-1 C.B. 65. The reasoning of those cases does not figure prominently in later constructive dividend cases and will not be discussed in this article.

161. 52 T.C. at 894.

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corporate solution of LCB, a fundamental distinction which the “benefit” concept for which *Rushing* is cited conceals.

As viewed by *Rushing* and *PPG*, the proper distinction between a direct and a derivative benefit to the common shareholder depends upon whether it is motivated by tax avoidance (direct) or by a legitimate business purpose (derivative). *Rushing* held that because LCB owned a shopping center it had a “significant interest” in the business of Briercroft, which by developing home sites on land adjacent to the shopping center could be expected to provide customers.¹⁶² Similarly, the court in *PPG* described the avoidance of Brazilian tax and exchange controls as “demonstrable business reasons.”¹⁶³ Consistent with that standard, it stated that six cases¹⁶⁴ cited by the Service

do not stand for the simplistic proposition, as respondent seems to suggest, that any transfer of funds or property between subsidiaries will give rise to a constructive dividend taxable to the parent corporation simply because the subsidiaries are under a common control. Instead, the cases that have found constructive dividends have for the most part involved various devices for siphoning off corporate profits, sham corporations, or corporate funds diverted for the direct benefit of the taxpayer-stockholder.¹⁶⁵

One of the six cases, *Makransky v. Commissioner*, indicates that “funds diverted for the direct benefit” of a shareholder refers to the *Wall* pattern.¹⁶⁶ The remaining five cases, however, involve “devices for siphoning off corporate profits.” In each instance the taxpayer attempted to avoid United States tax by improperly attributing income to someone other than the transferor corporation. But a constructive dividend is not the diversion of a tax attribute; it is the transfer of property. Had those five cases focused on the transfer of property out of corporate solution instead of on the diversion of United States income, the *PPG* court would more likely have seen that the fact patterns of the five cited cases are identical, for constructive divi-

162. *Rushing* has been categorized as a case in which “a proper corporate business purpose prevented a common shareholder from receiving a constructive dividend.” Charles A. Sammons, 30 CCH Tax Ct. Mem. 626, 636 n.15 (1971), *aff’d in part*, 472 F.2d 499 (5th Cir. 1973).

163. 55 T.C. at 1002.

164. The six cases were *Worcester v. Commissioner*, 370 F.2d 713 (1st Cir. 1966); *Equitable Publishing Co. v. Commissioner*, 356 F.2d 514 (3d Cir.), *cert. denied*, 385 U.S. 822 (1966); *Makransky v. Commissioner*, 321 F.2d 598 (3d Cir. 1963); *Biltmore Homes, Inc. v. Commissioner*, 288 F.2d 336 (4th Cir.), *cert. denied*, 368 U.S. 825 (1961); *Byers v. Commissioner*, 199 F.2d 273 (8th Cir. 1952), *cert. denied*, 345 U.S. 907 (1953); *Helvering v. Gordon*, 87 F.2d 663 (8th Cir. 1937).

165. 55 T.C. at 1003.

166. 321 F.2d 598, 601-02 (3d Cir. 1963). The *Wall* pattern involves payment by a corporation of a shareholder’s debt. *See* pp. 879-80 *supra*.

dend purposes, to that of *PPG*. Although the corporation in each of those five cases transferred funds in an attempt to divert United States tax attributes, the parent corporation in *PPG* made the same type of transfer in an attempt to divert a Brazilian tax attribute. It is illogical to conclude that diversion of a Brazilian tax attribute is a demonstrable business purpose, whereas an attempted diversion of a United States tax attribute represents "siphoning."

Quite apart from the illogical application of a business purpose criterion, there are three telling objections to applying a business purpose-tax avoidance dichotomy at all:

1. If the transfer could be justified wholly by corporate business considerations, the corporation would receive fair market value for the transfer by obtaining, for example, utility service,¹⁶⁷ a steady source of inventory, or potential customers. The question of a dividend arises *only* to the extent that value is not so received. The issue which must be resolved, therefore, is the business purpose for not receiving any value.

2. In almost every case the same result could have been achieved by transferring property in the manner constructed by the Service (a dividend distribution followed by a capital contribution to the commonly-owned corporation) as by transferring the funds directly between the companies. Doing so, however, would result in a dividend tax to the shareholders. Thus, regardless of why the funds are removed from the transferor's corporate solution, the reason why they are removed by *lateral transfer* rather than by distribution and contribution to the other subsidiary is an attempt to avoid that tax.

167. The consideration obtained for the transfer explains the result in *Commissioner v. Offutt*, 336 F.2d 483 (4th Cir. 1964), cited along with *Rushing* in *PPG*. See note 159 *supra*. In *Offutt*, a land development corporation needed to ensure the availability of adequate water and sewer services in order to obtain permits for the construction and furnishing of houses, and—as a practical matter—to sell the houses. The land development corporation offered to install the lines and facilities and to convey them to a county or municipality in return for a covenant to supply water and sewer services to purchasers of its houses. After the governmental authorities declined to accept the transfer on such terms, the facilities were transferred on similar terms to a utility corporation formed and wholly owned by Offutt, who also owned 40% of stock in the development company.

The Commissioner contended that transfer of these facilities, which eventually were sold for a substantial price, constituted a constructive dividend to Offutt. However, since the land development corporation previously had attempted without success to transfer the facilities to the county and municipality, and since, in addition, unrelated developers also transferred water and sewer facilities to the utility company in return for a covenant to operate them, the court quite properly concluded that in effect the land development corporation had received adequate consideration for the transfer. The fact that Offutt owned only 40% of the land development corporation provides an independent check: the other shareholders would not have let Offutt obtain a 100% economic interest in a valuable asset of that company without receiving equivalent value in return.

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3. A transfer between commonly-owned entities is not an economic event. Its significance is the tax consequences. Accordingly, economic considerations cannot distinguish between transfers which are solely of tax significance. The attempt to decide what tax significance should attach to an event which has no other significance creates disparities between taxpayers whose actions in all relevant respects are identical. For example, in *Sammons v. United States*,¹⁶⁸ a common shareholder was held to have received a constructive dividend for effecting a bargain sale of stock to an affiliate in contemplation of resale to a third party—exactly what was done in *PPG*. A dividend is a transfer of property; it is not a moral judgment as to whether items of income and deduction have been improperly allocated for United States tax purposes.

B. Davis: *The Supreme Court's Rejection of Business Purpose*

PPG was decided nine months after the Supreme Court's decision in *United States v. Davis*,¹⁶⁹ to which the Tax Court did not refer. *Davis* held that, in determining whether a redemption was "essentially equivalent to a dividend" under § 302(b)(1), Congress apparently had rejected court decisions "that had also considered factors indicating the presence or absence of a tax-avoidance motive."¹⁷⁰ It agreed with the statement of the Second Circuit that under § 302(b)(1) "the business purpose of a transaction is irrelevant in determining dividend equivalence."¹⁷¹

Although the conclusion in *Davis* rests on congressional intent in enacting a specific redemption statute,¹⁷² there is something profoundly unsatisfying about a tax structure in which business purpose and tax avoidance determine whether a constructive dividend has occurred but not whether an actual one has. Moreover, *Davis* comports with the concept of dividend as a taxable rather than an economic event, whose definition should therefore not depend upon purported economic considerations. Nevertheless, the Service has not attempted to extend the authority of *Davis* beyond the section which it con-

168. 433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971).

169. 397 U.S. 301 (1970).

170. *Id.* at 311 (footnote omitted).

171. *Id.* at 312, quoting *Hasbrook v. United States*, 343 F.2d 811, 814 (2d Cir.), *cert. denied*, 382 U.S. 834 (1965).

172. The Government argued that even before enactment of § 302(b)(1) in 1954, business purpose was irrelevant in testing the dividend equivalence of a redemption; but the Court did not find it necessary to decide the question. 397 U.S. at 310.

strued; and *Sparks Nugget, Inc.*,¹⁷³ the chief authority on which the Service relies to support its position in *Revenue Ruling 73-605* as to transfers between commonly controlled corporations,¹⁷⁴ does not consciously use a different criterion than cases that hold that business purpose justifies an intercompany transfer. Accordingly, the Service's disregard of business purpose in that ruling—a position this article endorses—most emphatically does not reflect present law.

C. *Present Law: Good Guys and Bad Guys*

Since present law uses the criteria of business purpose and tax avoidance, the principal differences among cases lie not in their fact patterns but in their conclusions. For example, *Sparks Nugget* and *Sammons v. United States*¹⁷⁵ both held that transfers from one commonly-owned corporation to another were constructive dividends. In *Sparks Nugget*, the common shareholder, Graves, argued that no tax or other benefit accrued to him by reason of excessive rentals paid by one of his wholly-owned corporations to others. Since all the corporations were in the highest tax bracket, he maintained that "any unjustified transfer of funds had no greater effect than the transfer of funds by an individual from one bank account to another."¹⁷⁶ Disagreeing, the Tax Court and Ninth Circuit held that Graves received "substantial"¹⁷⁷ or "immediate"¹⁷⁸ benefits from the arrangement. In finding these benefits, the Tax Court stated that "without such excessive rentals, it might have been necessary for Mr. Graves to make capital contributions to such corporations out of his income on which he paid taxes."¹⁷⁹

Since that statement describes almost every constructive dividend case in this area, it would, if consistently used as a criterion of "direct" benefit, reach the same result as the Service's position in *Revenue Ruling 73-605*. However, when the Tax Court reaches a conclusion that there should be no constructive dividend, it phrases the

173. 29 CCH Tax Ct. Mem. 318 (1970), *aff'd*, 458 F.2d 631 (9th Cir. 1972), *cert. denied*, 410 U.S. 928 (1973).

174. See p. 898 *supra*.

175. 433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971).

176. 29 CCH Tax Ct. Mem. at 336.

177. *Id.*

178. 458 F.2d at 637.

179. 29 CCH Tax Ct. Mem. at 337. The Ninth Circuit quoted a later paragraph in the Tax Court's opinion as summarizing the nature of those benefits:

Had the rentals been set at a lower figure—at the amount which would have been paid in the market place . . . , it would have been necessary for [the transferee] to have secured additional capital in some other manner, for example, by contributions from Mr. Graves.

458 F.2d at 637.

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analysis somewhat differently. Thus, in *Rapid Electric Co.*,¹⁸⁰ the Service contended that extensions of credit from one corporation (Rapid Puerto Rico) to its affiliate (Rapid New York) had become equity advances taxable as a constructive dividend to the common shareholder, Mr. Viola. However, rather than emphasizing—as *Sparks Nugget* did—that this avoided the necessity for a declaration of a dividend to the common shareholder, the court stated:

Whether we classify the extension of credit as debt or as some other kind of investment, the working capital which was provided to Rapid New York by Rapid Puerto Rico remained in the corporate solution throughout the years in question. There is no indication that any of it was siphoned off to or for the benefit of Viola. Cf. *Sparks Nugget, Inc.* . . .¹⁸¹

These two cases, like most of the others, essentially involve the same kind of transaction. Whether the court chooses to stress that a transfer avoids the making of a distribution, or that the transfer serves a business purpose, it is evident, first, that the “direct benefit” criterion represents a conclusion, not an analysis, and second, that different conclusions are being reached with respect to essentially identical transactions. Because of those similarities in fact patterns, a court can always find authority to support its conclusion. In *Sparks Nugget*, for example, the Ninth Circuit stated that the arrangement devised by the common shareholder was similar to one “recently condemned”¹⁸² by the Fifth Circuit in *Sammons v. United States*.¹⁸³ It could just as well have stated that the arrangement was similar to the one recently approved by the Tax Court in *PPG*.

The word “condemned” is peculiarly appropriate. Since there is no rational basis for distinction, a strong suspicion must arise that courts are deciding constructive dividend cases on the basis of a moral judgment as to whether the shareholder before them is the type of fellow who generally avoids taxes. Thus, in *Ross Glove Co.*,¹⁸⁴ Mr. Ross was dealt with quite leniently. Since “[t]here *may* have been substantial business reasons”¹⁸⁵ for his foreign manufacturing company to forbear from collecting advances made to his domestic sales corporation, the advances, regardless of whether debt or equity, did not constitute a dividend. The court noted that “Mr. Ross did not per-

180. 61 T.C. 232 (1973), *acquiesced in result only*, 1974-2 C.B. 4.

181. *Id.* at 240.

182. 458 F.2d at 638.

183. 433 F.2d 728 (5th Cir. 1970), *cert. denied*, 402 U.S. 945 (1971).

184. 60 T.C. 569 (1973), *acquiesced in result only*, 1974-2 C.B. 4.

185. *Id.* at 596 (emphasis added).

sonally utilize the advances"¹⁸⁶ By contrast, the Fifth Circuit reasoned in *Sammons v. United States* that the taxpayer received a constructive dividend when

[i]n reality . . . , [he] took money from his five corporations and placed it in a sixth. It is of little consequence that he personally received no money from the transaction, for it is the power to dispose of income and the exercise of that power that determines whether taxable income has been received. *Helvering v. Horst*¹⁸⁷

The inappropriateness of citing *Horst* to support a constructive dividend conclusion reflects the confusion in *Columbian Rope* between property and tax attributes.¹⁸⁸ That confusion, not always accompanied by a citation to *Horst*, results in the failure by decisions such as *PPG*, *Columbian Rope*, and *Sammons v. United States* to discriminate between tax avoidance at the corporate level, which arises only when the corporation attempts to transfer tax attributes, and tax avoidance at the shareholder level, which can occur by the transfer of funds regardless of whether tax attributes are shifted. Courts therefore are more likely to find that a shareholder has engaged in tax avoidance when the transfer of funds coincides with an attempt to transfer corporate income for United States—but not, as in *PPG*, for foreign—tax purposes.¹⁸⁹ Examples, in addition to *Sammons v. United States* and the five cases described by *PPG* as involving “devices for siphoning off corporate profits,”¹⁹⁰ are *Ross Glove Co.* and *Robert Trent Jones*.¹⁹¹ Although *Ross Glove* approved explicit intercompany

186. *Id.*

187. 433 F.2d at 732.

188. See pp. 900-02 *infra*. Other cases citing *Horst* to support a finding of constructive dividend include *George W. Knipe*, 24 CCH Tax Ct. Mem. 668 (1965), *aff'd sub nom. Equitable Publishing Co. v. Commissioner*, 356 F.2d 514 (3d Cir. 1966); *Byers v. Commissioner*, 199 F.2d 273 (8th Cir. 1952).

189. Even where an allocation of income is made, however, the court will not find a constructive dividend when it is convinced of the taxpayer's good faith. For example, in *R.T. French Co.*, 60 T.C. 836 (1973), the taxpayer did not contest an allocation to it of royalty income attributable to the free use by its foreign affiliates of patents, trademarks, and other intangible assets. In rejecting the Service's contention that the income so allocated should have been considered constructively received by the taxpayer and paid as a dividend to the common foreign parent corporation, the court stated:

The dividends actually declared and paid by petitioner in each of the years in issue (\$1,750,000 in each year) were so vastly in excess of the additional amounts that the Commissioner would treat as dividends to petitioner's parent corporation (\$18,671.90 in 1963 and \$19,566.18 in 1964) that we cannot believe that the free use of petitioner's intangibles represented an *attempt* by the parent to direct further benefits to itself.

Id. at 856 (emphasis added).

190. See note 164 and p. 903 *supra*.

191. 34 CCH Tax Ct. Mem. 488 (1975).

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advances, it reserved the question—not raised by the Service—of whether the Tax Court's reallocation of income to the domestic company resulted in a constructive dividend to the common shareholder, Mr. Ross.¹⁹² That reallocation had resulted from the court's finding that the domestic corporation had paid too high a price for raw materials purchased from its foreign affiliate; unlike the direct advance, the excess price paid could not be justified as having any business purpose. The domestic corporation, of course, received no consideration for either the direct advance or the overcharges. Similarly, in *Robert Trent Jones*, the taxpayer's Bahamas corporation (Planners), which designed golf courses, was unable to collect its fee from his other Bahamas corporation (Contractors) because of exchange controls. In holding that the failure to collect did not cause a constructive dividend, the opinion stated:

We think it also important that the fee (\$24,000) petitioner sought to have Contractors pay Planners was standard in the industry. Thus we find the instant case to be distinguishable from those cases such as *Sammons v. United States* . . . ; *Sparks Nugget, Inc. v. Commissioner* . . . ; *Worcester v. Commissioner* . . . ; [and] *Equitable Publishing Co. v. Commissioner* . . . , involving excessive payments for services or property by one related corporation to another, where it can be said, unlike here, that the stockholders of the recipient or transferee corporation received a tangible benefit.¹⁹³

By focusing on the fairness of the uncollected fee rather than on the transfer of funds, the court overlooked the fact that the transferor was Planners, not Contractors; and Planners had no reason to pay Contractors anything at all.

D. *Two Loose Ends: Insolvent Transferees and Differences in Proportionate Ownership*

Formulation of the dividend test with respect to intercompany transfers sometimes differs from the phrasing used to test for dividends incident to acquisitions. In the context of an acquisition, as in *Sullivan*,¹⁹⁴ discharge of an obligation is equated with economic benefit; by contrast, in the context of an intercompany transfer, it is recognized as an alternative basis for dividend taxation. For example,

192. 60 T.C. at 596 n.5.

193. 34 CCH Tax Ct. Mem. at 492.

194. See pp. 880-83 *supra*.

the Tax Court stated in *Ross Glove* (and used a virtually identical formulation in *Rapid Electric Co.*¹⁹⁵):

It is well established that a corporate distribution can be treated as a dividend if it is made for the personal benefit of a shareholder *or* in discharge of a personal obligation of a shareholder.¹⁹⁶

The difference can be seen in *Tirzah A. Cox*,¹⁹⁷ which—citing *Wall*—held that funds transferred from one company (Commonwealth) to its insolvent sister corporation (C & D) constituted a dividend *only* to the extent that C & D used those funds to pay a note for which Copple, a common shareholder, was personally liable as endorser.¹⁹⁸ An amount used by C & D to make a loan (which when repaid apparently could have further reduced the note)¹⁹⁹ was not so taxed.

Cox is correct in its reliance on *Wall* to the extent that C & D would be insolvent but for the transfer; to that extent, the funds were transferred not to C & D but to satisfy a debt owed by Copple to C & D's creditors. As in *Wall*, the satisfaction by Commonwealth of a debt owed by Copple should be treated as a dividend to Copple. But *Cox* does not go far enough, because it fails to consider the tax consequence of transfers from Commonwealth to C & D after C & D had become solvent.

To illustrate, assume that C & D had \$80 of assets and \$200 of liabilities, all of which Copple had guaranteed. Assume further that Commonwealth transferred \$200 to C & D, all of which was used to pay C & D's debts. Had Copple actually paid the creditors \$200 and been subrogated to their claims against C & D, he would have received only \$80 as a C & D creditor. Thus, although \$120 of the \$200 satisfies a liability of Copple's which C & D could not, and constitutes a dividend from Commonwealth to Copple under the principle of *Wall*, the remaining \$80 is an amount which C & D *can* pay to its creditors. The \$80 should be treated as a constructive dividend because it increases the amount of Copple's assets outside Commonwealth's corporate solution. The reason for such increase, however, is not that Commonwealth is satisfying any liability owed by Copple, but that Commonwealth is raising the value of Copple's equity in C & D from zero to \$80.

195. 61 T.C. 232, 239 (1973).

196. 60 T.C. at 595 (emphasis added).

197. 56 T.C. 1270 (1971).

198. *Id.* at 1280.

199. As to the amount of the debt and repayments, see 56 T.C. at 1273-74.

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The analysis in *Cox* is therefore faulty in three respects: first, its *Wall* rationale should apply only to the extent that C & D would otherwise be insolvent; second, transfers once C & D is solvent should also constitute a dividend, not as a discharge of obligation under *Wall* but as intercompany transfers; and third, the use to which C & D puts the funds—immediate repayment of its debt or investment which can be used to repay such debt in the future—should be irrelevant.

Where an intercompany transfer is not lateral, as in *Cox*, but from a parent to an insolvent subsidiary, the tax characterization is ordinarily not a dividend but a contribution to the subsidiary's capital. However, where, as in *Charles A. Sammons*,²⁰⁰ the shareholder of the parent has guaranteed the debts of a subsidiary which thereafter becomes insolvent, *Wall* requires that the capital contribution to the subsidiary be treated as a dividend to the parent's shareholder, but only to the extent the subsidiary would otherwise be unable to pay such debts. *Sammons* was therefore incorrect in holding, without regard to the amount necessary to enable the subsidiary to become solvent, that the transfer constituted a dividend to the extent used to pay debts to, or guaranteed by, the parent's shareholder.

A separate issue, present but not discussed in *Cox*,²⁰¹ arises when the transferor and transferee corporations are not owned in the same proportions. In both *Cox* and *Joseph Lupowitz Sons, Inc. v. Commissioner*²⁰² the Service initially contended that the transfer constituted a constructive dividend in proportion to shareholdings in the transferee corporation; that contention was amended in both cases to refer to shareholdings in the transferor, and the Third Circuit in *Lupowitz* indicated that shareholdings in the transferee corporation were irrelevant.²⁰³

But the shareholdings in both corporations *are* relevant. A shareholder with, for example, a 20% interest in the transferor but a 30% interest in the transferee can receive only \$20 of a \$100 transfer with respect to his stock in the distributing corporation. The re-

200. 30 CCH Tax Ct. Mem. 626 (1971), *aff'd in part*, 472 F.2d 449 (5th Cir. 1973). The guarantor shareholder assumed the debts of the subsidiary. It appears that the transferred funds—which were then used to pay the debt to the shareholder—did not render the subsidiary solvent.

201. The court in *Cox* did not tax the minority shareholders on the transfer, perhaps because the transfer was instigated by and within the control of Copple, the common shareholder.

202. 497 F.2d 862 (3d Cir. 1974), *rev'g in part, aff'g in part, and remanding* 31 CCH Tax Ct. Mem. 1169 (1972).

203. See 56 T.C. at 1277 n.4 (*Cox*); 497 F.2d at 868 n.14 (*Lupowitz*).

maining \$10 may be received as a gift²⁰⁴ or as compensation, or may simply represent funds that he has appropriated from the other shareholders. The \$10 may therefore be income but not a dividend. On the other hand, where a 30% shareholder in the transferor has only a 20% interest in the transferee, he should be considered to receive \$30 as a dividend only if he is making a gift, paying compensation, or otherwise attempting to transfer \$10 to other people.

IV. Conclusion

This article has attempted to show that one tax concept can have a logical and consistent meaning. The attempt, which challenges the present perception of dividend distributions, rests on a larger assumption that the meaning of basic tax concepts should not vary from particular issue to issue.

The contrary view of judges like Friendly and Tannenwald—that the meaning of a concept depends on its context in each particular Code section—increases the uncertainty and complexity of tax law by abandoning fixed points of reference. If two sections of the Code intend different meanings, they can use different words;²⁰⁵ and unintended results produced by consistent interpretation can be more easily corrected than can the uncertainty and complexity arising from an ad hoc judicial approach to meaning.

Also implicit in this article is a sense that the current call for statutory simplicity is misdirected. Too often, such simplicity is advocated as a way of reducing the expense and effort involved in understanding tax law. But readers who have followed the argument this far will be aware that the *Code* did not create the difficulty which the courts and Service have had in analyzing distributions, and a shorter statute will not eliminate it. Tax simplicity inheres in consistency, not in brevity of language, since questions of substance, form, and tax avoidance will not disappear regardless of how little detail the Code specifies. Rather, to the extent that the Code does not supply detailed guidance to specific questions, the answers will be determined by courts without the benefit of a clearly articulated

204. This possibility was overlooked in *Walter K. Dean*, 57 T.C. 32 (1971), which mistakenly followed *Commissioner v. Offutt*, 336 F.2d 483 (4th Cir. 1964) (discussed at note 167 *supra*) in a situation in which property was not transferred for adequate consideration.

205. Alternatively, a term can be defined by statute for purposes only of a specific provision. For example, control is defined as ownership of 50% of a corporation's stock for purposes of § 269, but 80% for purposes of §§ 301-368 (except for § 304). See § 368(c).

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standard. Under such circumstances, improvement in either predictability or ease of comprehension is doubtful.

The simplicity of a system should be gauged by the variety of results which a single concept can account for; its complexity, by the need for exceptions.²⁰⁶ By explaining more results and reducing exceptions, consistency in interpreting the same tax concept in different contexts will represent a step towards simplicity. The idea of dividend distributions proposed by this article offers a coherent explanation of both the bootstrap acquisition cases and those involving transfers between affiliates; and its coherence—the ability to treat the cases as a rational whole—suggests the way to a simpler tax law.

206. The substance of tax rules could become substantially less complex by reducing the exceptions to progressive taxation listed in § 57, generally referred to as tax preferences. Nevertheless, proponents of an easier-to-understand tax law seldom recommend abolition of one of the provisions that causes the most difficulty—capital gains—and generally concentrate their criticism on the complexity of the statute rather than on its relief or preference provisions. To its credit, the *Report on Complexity*, *supra* note 3, at 333-51, criticizes both.