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CORPORATE DIVIDENDS AND OTHER NON-LIQUIDATING DISTRIBUTIONS IN CASH, PROPERTY, STOCK, AND OBLIGATIONS

BORIS I. BITTKER*

A. DISTRIBUTIONS IN CASH

UNDER the Internal Revenue Code of 1954, the corporation is a separate taxable entity, so that corporate income is taxed to the corporation and dividends paid by the corporation are taxable to the shareholders. The framework for the taxation of corporate distributions is provided by Sections 301(a), 301(c), and 316 of the Code. By virtue of these provisions, a corporate distribution is a "dividend" that must be included in gross income under § 301(c)(1) and § 61(a)(7) if, and to the extent that, it comes out of "earnings and profits" of the corporation accumulated after February 28, 1913 or out of earnings and profits of the taxable year. Most distributions of most corporations fall well within this category of taxable "dividends" and hence are taxed as ordinary income to the shareholder, subject to the §50 exclusion of § 116 and the 4 percent dividends received credit of § 34 if the shareholder is an individual or to the 85 percent dividends received deduction of § 243 if the shareholder is a corporation. To the extent that a distribution by a corporation is not covered by current or post-1913 earnings and profits, however, it is treated by § 301(c)(2) as a return of capital to the shareholder, to be applied against and in reduction of the adjusted basis of his stock. If the distribution exceeds the adjusted basis of the stock, the excess is ordinarily taxed as capital gain, with an exception of minor importance for distributions out of increase in the value of corporate property accrued before March 1, 1913.1

If we assume a corporation newly organized for cash, the reason for gearing the taxability of its distributions to its record of earnings and profits is clear enough. Until the corporation has engaged in profitable operations, any distribution to its original stockholders is a return of their investment rather than income. Once the corporation has realized profits, on the other hand, its distributions may pro tanto be fairly regarded as income to the stockholders.

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This article is adapted (and reprinted by permission of the author) from a chapter of a book, designed to serve as a guide or handbook to the problems of Subchapter C of the Internal Revenue Code (the organization and capital structure of corporations, distributions in cash and property, stock dividends, stock redemptions and partial liquidations, preferred stock bail-outs, complete liquidations, collapsible corporations, divisive reorganizations, and mergers, consolidations, and other acquisitions).
1 § 301(c)(3)(A) and (B).
CORPORATE DIVIDENDS

The equity of § 316 and § 301(c) is far less clear if we assume that after a period of corporate profits the stock changes hands and that before additional earnings arise (the next day, if you will) there is a distribution to the new stockholder. Has not he received a return of his capital? The economist might say that a distribution in these circumstances ought to be regarded as a return of capital, but § 301(c) and § 316 of the Internal Revenue Code are inescapable, so that to the extent of his share of the corporation's earnings and profits, the surprised stockholder has realized income. This "miracle of income without gain"—the phrase is from Powell, "Income from Corporate Dividends,"—long ago was attested by the Supreme Court in United States v. Phellis:

Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon.

In point of fact, however, the purchaser of stock must bid against many other potential buyers, who would be affected in varying degrees by the income tax on a dividend and some of whom may be tax exempt organizations, so that the price could rarely if ever be accurately "discounted by the prospect of an income tax to be paid" on dividends that may be declared immediately after the stock is purchased. Moreover, the distribution will be a "dividend" under § 316 only if it is paid from the corporation's earnings and profits, and since the calculation of earnings and profits may be a complex operation, the purchaser would not know the proper discount to apply (except possibly in the case of a closely-held corporation) even if he were so foresighted as to anticipate the problem.

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2 35 Harv. L. Rev. 363 (1922).
3 257 U.S. 156 (1921).
4 257 U.S. at 171-2.
5 Infra, p. 56.
Just as the concept of earnings and profits may be unfair to a shareholder who buys stock before a corporate distribution, so on occasion it may with equal irrationality shower him with riches. If the corporation into which he buys is a deficit corporation, distributions by the corporation may be treated as wholly or partly tax-free returns of capital to the shareholder even though they reflect earnings after he buys his stock. This bonanza can occur if the corporation has neither post-1913 nor current earnings and profits; and if (to reverse the "discount" theory of the Phellis case) the shareholder did not pay a premium when he bought his shares for the tax advantage lurking in the corporation's deficit.

The inequities of relating the tax status of corporate distributions to the corporation's earnings and profits grow out of the felt need for a method of protecting returns of capital from the tax on dividends; and while a better response to this need could no doubt be devised, Congress has shown no disposition to depart from the present method.

Before turning to the details of the general rule set out above, under which a distribution by a corporation is a "dividend" if it comes out of current or post-1913 earnings and profits and a return of capital to the extent that it exceeds the earnings and profits, it should be noted that special rules are provided for certain categories of distributions, among which are:

1. Distributions in kind, i.e., of property other than money.
2. Distributions of the distributing corporation's own obligations.
3. Distributions of the corporation's own stock or of rights to purchase its stock.
4. Distributions in redemption of stock, including partial liquidations and complete liquidations.
5. Distributions in corporate organizations, reorganizations and similar transactions.

Constructive or disguised distributions. The rules of § 301(c) (under which corporate distributions are to be treated as "dividends" or returns of capital, depending on the amount of the corporation's current and post-1913 earnings and profits) come into play only if a

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6 Without attempting to work out the details, one approach would be to treat all receipts from the corporation as taxable income, and to compute the shareholder's gain or loss on his capital investment when he sells or otherwise disposes of his shares or when they become worthless. Another method of taxing the shareholder would be to apply all distributions against basis until his cost was recouped, taxing all subsequent distributions or receipts as ordinary income, capital gain, or a combination thereof.


8 Infra, p. 64.
9 Infra, p. 78.
10 Infra, p. 80.
corporation makes a “distribution . . . to a shareholder with respect to its stock.” According to the Regulations, § 301 “is not applicable to an amount paid by a corporation to a shareholder unless the amount is paid to the shareholder in his capacity as such.” Thus, if a corporation distributes property to a shareholder who is also a creditor of the corporation in satisfaction of his claim, the distribution is not governed by § 301. This example is given by the Senate Report on the 1954 Code; other examples would be a distribution to a shareholder-employee as compensation for services or to a shareholder-vendor as payment for property. Even if such transfers are regarded as “distributions,” they are not made to a shareholder “with respect to [his] stock,” as required by § 301(a), and hence their tax consequences are governed by other sections of the Internal Revenue Code.

A distribution to a shareholder in his capacity as such, however, is subject to § 301 even though it is not declared in a formal fashion. Informal, constructive, and disguised distributions are commonly encountered in the case of closely-held corporations. Although publicly-held corporations rarely engage in the practice, some railroad and public utility corporations are parties to leases requiring the lessee to pay a fixed annual amount directly to the lessor’s shareholders, an arrangement that is the equivalent of a payment of rent to the lessor, followed by a “distribution” by the lessor corporation. Informal distributions may assume many forms, of which the most important are the following:

1. “Loans” by a corporation to its stockholders that are not intended to be repaid.
2. Corporate “expenses” that are incurred to benefit stockholders, rather than to further the corporation’s trade or business. This category of informal distributions ranges from borderline expenses (e.g., for travel and entertainment), where an allocation between the individual and the corporation may be in order, to the blatant payment of personal expenses in an aura of fraud.

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11 § 301(a).
12 Regs. § 1.301-1(c).
14 The label seems inappropriate if the consideration received by the corporation is equal to the value of the stock transferred, despite Palmer v. Commissioner, 302 U.S. 63 (1937) (“a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property”).
15 See United States v. Joliet & Chicago R. Co., 315 U.S. 44 (1942); Commissioner v. Western Union Telegraph Co., 141 F.2d 774 (2d Cir. 1944), cert. denied, 322 U.S. 751.
17 E.g., see Lash v. Commissioner, 75,087 P-H Memo TC, aff’d per curiam, 245 F.2d 20 (1st Cir. 1957).
ican Properties, Inc. v. Commissioner, it was held that the expenses of designing, constructing and racing speed boats, paid by a one-man corporation, were not deductible under § 162(a) by the corporation and constituted disguised dividends to the sole shareholder who "had an insatiable desire for speed."

In Casale v. Commissioner, however, it was held that premiums on a policy insuring the life of the corporation's sole stockholder were not constructive dividends to him, reversing a Tax Court judgment based on the theory that the corporation "was no more than a conduit running from the insurer to [the stockholder], or his beneficiaries, with respect to any payments which might come due under the insurance contract."

3. Sales of corporate property for less than fair market value. Although the applicable regulations state flatly that a transfer of property for less than its fair market value is ipso facto a distribution, it may also be necessary that the "spread" be substantial or that the transaction be intended as a distribution. The Palmer case also holds that the grant to shareholders of options to purchase corporate property is not a taxable distribution, even though the options have a market value; but it is not entirely clear that this principle would be applied if there were a substantial "spread" between the option price and the value of the optioned property when the options were distributed.

4. Allowing shareholders to use corporate property without paying a fair rent. The Internal Revenue Service has ruled that any "spread" between the amount paid by the shareholders and the fair rental value of the property is a distribution subject to § 301. This theory imposes an arm's length relationship on the shareholders and their corporation (as provided by Regs. § 1.301-1(j) in the case of bargain sales of corporate property). But on occasion the deficiency

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18 28 T.C. 1100 (1957), affm'd. per curiam, — F.2d — (9th Cir. 1958).
19 See also Greenspon v. Commissioner, 229 F.2d 947 (8th Cir. 1956) (corporation's payments for creating and maintaining "a unique horticultural show place" at sole shareholder's farm disallowed under § 162(a) and taxed as constructive dividends).
20 247 F.2d 440 (2d Cir. 1957).
22 See Regs. § 1.301-1(j) (the calculation of the "amount" of the distribution if the shareholder is another corporation results from the special rule of § 301(b)(1)(B), infra, p. 74); Timberlake v. Commissioner, 132 F.2d 259 (4th Cir. 1942); Young v. Commissioner, 5 T.C. 1251 (1945).
24 Rev. Rul. 58-1, 1958-1 C.B. 173; 58th St. Plaza Theatre, Inc. v. Commissioner, 195 F.2d 724 (2d Cir. 1952), cert. denied, 344 U.S. 820; see also Dean v. Commissioner, 9 T.C. 256 (1947) (shareholders' use of corporation's riding horses not a constructive distribution, where exercising them was beneficial to corporation).
is based on the corporation's out-of-pocket expenses, rather than on the fair rental value of the property.25

5. Payments by a corporation to its shareholders, if excessive in amount, in the form of rent, royalties, purchase price of property, etc.26

6. Purported "salaries" paid to a stockholder or to the relative or donee of a stockholder. Under § 162(a) the corporation is entitled to deduct "a reasonable allowance for salaries or other compensation for personal services actually rendered." If no services are rendered, the "salary" is a distribution to the stockholder who received it or whose relative or donee received it. It is also often assumed that if services are rendered but the compensation paid is excessive, the excess should be treated as a distribution.27 It is arguable, however, that a payment might exceed what is "reasonable" under § 162(a), without thereby becoming a "distribution" under § 301, and that "unreasonable compensation" is taxable to the recipient as compensation rather than as a distribution.28 On this theory, an alleged salary might be allocated among the first two, or all three, of the following categories: (a) compensation, deductible by the corporation under § 162 and taxable to the recipient as compensation; (b) unreasonable compensation, not deductible by the corporation under § 162 but taxable to the recipient as compensation; and (c) distributions disguised as compensation, not deductible by the corporation and taxable to the shareholder (who is not necessarily the recipient) only under § 301.

7. "Interest" on hybrid securities or on evidences of indebtedness issued by an under-capitalized corporation. So-called interest has often been treated for tax purposes as dividends because paid with respect to hybrid securities or evidences of indebtedness issued by an under-capitalized corporation.29

8. Various fraudulent devices, such as diverting payments by customers and others before they reach the corporation, collecting "kick-backs" from the corporation's suppliers and employees, etc.30

25 See Lash v. Commissioner, § 56,087 F-H Memo TC, aff'd per curiam, 245 F.2d 20 (1st Cir. 1957) (80 percent of corporation's automobile expense treated as constructive distribution to shareholder who made personal use of corporate vehicles). But see Peacock v. Commissioner, 256 F.2d 160 (5th Cir. 1958) (rental value is a gift to the shareholders in absence of evidence that it was intended as compensation for services).

26 See Byers v. Commissioner, 199 F.2d 273 (8th Cir. 1952); Crabtree v. Commissioner, 22 T.C. 61 (1953), aff'd per curiam, 272 F.2d 807 (2d Cir. 1955); Staab v. Commissioner, 20 T.C. 834 (1953).

27 See Regs. § 1.162-8.


30 Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956); Simon v. Commissioner, 248 F.2d 869 (8th Cir. 1957); Myers v. Commissioner, 21 T.C. 331 (1953).
In the foregoing, it has been assumed that the payments in question, not being what they purport to be, are “distributions” under § 301, with the tax consequences to the shareholder depending upon the corporation’s earnings and profits. “Unreasonable compensation,” as indicated above, may be subject to different principles. There are also several cases concerning the unlawful diversion of corporate funds (category 8 above), in which it was held that the shareholders were taxable under § 61(a), without regard to the corporation’s earnings and profits.61 These cases, which can be reconciled with § 301 only by the unsatisfactory assumption that the funds were not taken by the stockholders in their capacity as such, are inconsistent with later cases in their own circuits;62 moreover, nothing in the Hartman and Davis opinions suggests why the unlawful diversion of corporate funds by shareholders should be treated differently from the other forms of informal or disguised distributions described above.

On the other hand, some of the payments described above (e.g., loans; diversions; rent-free use of property) could be intended as compensation rather than as distributions.63

Finally, it should be noted that a payment is more likely to be taxed as a constructive dividend if the stockholders share in it pro rata, but equal treatment is not indispensable. In Lengsfeld v. Commissioner,64 for example, distributions to several shareholders were taxed as dividends; the others, who did not participate, were related to the recipients and consented to the distributions.65

“Dividend”—A Term of Art. Under § 301(c), a distribution is includible in the shareholder’s gross income to the extent that it is a “dividend,” as defined in § 316; the balance of the distribution, if any, is a return of capital under § 301(c)(2) and (3). The term “dividend” as defined for income tax purposes by § 316(a) does not correspond to the term “dividend” under state law, with the result that a corporate

For a more complete collection of cases on informal, disguised, and constructive distributions, see Comment, Disguised Dividends: A Comprehensive Survey, 3 U.C.L.A. Law Rev. 207 (1956); Toll, Constructive Dividends, 1951 So. Calif. Tax Inst. 211.

61 Hartman v. United States, 245 F.2d 349 (8th Cir. 1957); Davis v. United States, 226 F.2d 331 (6th Cir. 1955), cert. denied, 350 U.S. 965.
62 Drybrough and Simon, supra, note 30.
63 Chandler v. Commissioner, 119 F.2d 623 (1941); see also Silverman v. Commissioner, 253 F.2d 849 (8th Cir. 1958). The characterization of an amount received by a shareholder may be important in determining whether (a) the corporation can deduct it, (b) it reduces the corporation’s earnings and profits in computing the taxability of future distributions, (c) the recipient must treat it as ordinary income under § 61(a) or may treat it in whole or in part as a return of capital under § 301(c), and (d) the recipient is entitled to the dividends received credit of § 34 or to the dividends received deduction of § 1245.
64 241 F.2d 508 (5th Cir. 1957).
65 See also Paramount-Richards Theatres, Inc. v. Commissioner, 153 F.2d 602 (5th Cir. 1946).
distribution may be a "dividend" under § 316(a), although it impairs capital or is otherwise unlawful under state law. Conversely, it is possible for a distribution to constitute a lawful "dividend" under state law without qualifying as a "dividend" under § 316(a). In the former instance, the "dividend" will ordinarily be taxable to the stockholder under the "claim of right" doctrine, notwithstanding his potential liability to creditors under state law.

The definition of "dividend" in § 316 is two-edged: a distribution by a corporation to its shareholders is a "dividend" if it is made (1) out of earnings and profits accumulated after February 28, 1913, or (2) out of earnings and profits of the taxable year. For present purposes, earnings and profits of the current year can be regarded as roughly synonymous with taxable income; accumulated post-1913 earnings and profits, as the sum of the earnings and profits since 1913, less dividends paid in earlier years, or as the equivalent of earned surplus. As will be seen in the next section, however, many adjustments may be required to convert taxable income and earned surplus into current and accumulated earnings and profits; and the definitions just suggested are only a stop-gap. It is perhaps unnecessary to add that none of these categories is represented by a bank account or other specific corporate assets: a distribution is "out of" current earnings and profits if the corporation enjoyed a profit in the taxable year, and no "tracing" or "earmarking" of funds or assets is required.

The first part of § 316(a), providing that a distribution is a "dividend" if it comes from earnings and profits accumulated since February 28, 1913, looks to the financial success of the corporation over the long haul. If it has been profitable since 1913 (or since organization, if it was incorporated after 1913), distributions will be taxed to the shareholders as "dividends." The exemption of earnings and profits accumulated before February 28, 1913 (the date of the first federal income tax imposed after the adoption of the Sixteenth Amendment) is a matter of legislative grace, rather than constitutional right. The exemption, however, affects only corporations organized before 1913 and successors of such corporations; and since even a corporation that belongs to this select group is likely to keep its distributions to shareholders well within its current or recent earn-

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36 As Rudick, in the article cited infra, p. 55, has said (p. 886): "... what the distributing corporation may call a dividend, or what the state law may call a dividend, or even what the recipient thinks of without question as a dividend, is not necessarily a "dividend" for federal income tax purposes." On state law, see Kreidmann, Dividends—Changing Patterns, 57 Col. L. Rev. 372 (1957).

37 United States v. Lesoine, 203 F.2d 123 (9th Cir. 1953); but see Knight Newspapers, Inc. v. Commissioner, 143 F.2d 1007 (6th Cir. 1944).

38 Lynch v. Hornby, 247 U.S. 339 (1918); see also Helvering v. Canfield, 291 U.S. 163 (1934), holding that pre-1913 earnings and profits may be wiped out by post-1913 losses and need not be restored from later earnings.
ings and profits, the complicated network of law built on the 1913
benchmark is of interest to very few shareholders. The Treasury
Department has made several assaults on the immunity of pre-1913
earnings and profits, but has not been able to persuade Congress to
repeal it. 39

The second part of § 316(a) provides that a distribution is a
"dividend" if it comes from earnings and profits of the taxable year. 40
Since most distributions are made by corporations that are currently
profitable, § 316(a)(2) often makes it unnecessary to compute the
corporation's post-1913 accumulated earnings and profits. This makes
for simplicity, but it also means that a distribution may be a taxable
"dividend" even though the corporation has a deficit; if the concept
of earnings and profits serves any useful purpose, it is partly under­
mined by § 316(a)(2). For the original shareholders of a corporation,
there is no economic difference between a distribution before the cor­
poration has had any earnings, which is not a "dividend" under either
§ 316(a)(1) or § 316(a)(2), and a distribution after it has suffered
a loss; but the latter is a "dividend" under § 316(a)(2) if there are
current earnings, even though they are insufficient to repair the deficit.
For shareholders who acquire their stock after the deficit but before
the earnings, to be sure, § 316(a)(2) is more defensible; but here
§ 316(a)(2) does not go far enough, since its impact can be avoided
if the distribution can be postponed until a year in which the cor­
poration has no earnings and profits.

If the corporation has neither post-1913 accumulated earnings
and profits nor current earnings and profits, a distribution cannot be
a "dividend." It is, instead, subject to § 301(c)(2) and (3). Under
§ 301(c)(2), the distribution is applied against and reduces the ad­
justed basis of the shareholder's stock. If the distribution exceeds in
amount the adjusted basis of the stock, the excess is subject to
§ 301(c)(3). It will be treated as gain from the sale or exchange of
property (and thus as capital gain if the stock is a capital asset).

39 See House Ways and Means Committee, 77th Cong., 2d sess., Hearings on Reve­
nue Revision of 1942, pp. 1692 ff.; H. Rept. No. 2319, 81st Cong., 2d Sess., reprinted

40 § 316(a)(2) has a curious ancestry. It was enacted in 1936 as a relief measure
when the undistributed profits tax was in effect. That tax was imposed on the undis­
tributed part of corporate income, computed by deducting "dividends" from total income.
Unless a deficit corporation could treat distributions out of current earnings as "divi­
dends" for this purpose, it would be unable to avoid the undistributed profits tax no
matter how large its distributions to stockholders were. To enable such corporations to
obtain a credit for "dividends" paid out of current earnings, § 316(a)(2) was enacted.
Apparently no thought was given to the effect of the new subsection apart from the
undistributed profits tax. Its impact can sometimes be avoided by postponing the
distribution until the next year. If the corporation has no earnings in that year and
still has a deficit, the distribution will be receivable tax-free since it will fall under
neither § 316(a)(1) nor § 316(a)(2).
unless it is out of a pre-1913 increase in the value of the corporation's property, in which event it will enjoy an exemption from tax.\textsuperscript{41}

The second sentence of § 316(a) lays down an irrebuttable presumption that every distribution is out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. This prevents "earmarking" a distribution to control its tax status; \textit{e.g.}, a corporation having current earnings and profits, post-1913 accumulated earnings and profits, and pre-1913 accumulated earnings and profits, cannot make a distribution from the pre-1913 earnings and profits until the current and post-1913 earnings and profits have been exhausted. Once current, post-1913, and pre-1913 earnings and profits have been exhausted, however, the corporation may be able to earmark a distribution so as to give it the exemption conferred by § 301(c)(3)(B) (pre-1913 increase in value) and thus protect its shareholders against a capital gain tax under § 301(c)(3)(A).\textsuperscript{42}

In determining whether a distribution is out of earnings and profits of the taxable year, § 316(a)(2) provides that the earnings and profits for the year are to be computed as of the close of the taxable year without diminution by reason of distributions during the year. This means that a distribution will be a "dividend" if the corporation has earnings and profits at the end of the taxable year, even though it had none when the distribution occurred; contrariwise, a distribution that appeared to be a "dividend" when made may turn out to be a return of capital because the corporation has no earnings and profits at the end of the year. If the distributions for the year exceed in amount both the earnings and profits of the taxable year and the post-1913 accumulated earnings and profits, the Regulations prescribe a method of allocating the two categories of earnings and profits to the various distributions in order to ascertain the "dividend" component of each one.\textsuperscript{43}

There are two landmark articles on earnings and profits, both outdated at many points but still useful: Rudick, "Dividends" and "Earnings or Profits" Under the Income Tax Law: Corporate Non-Liquidating Distributions;\textsuperscript{44} Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions.\textsuperscript{45}


\textsuperscript{42} For an example of the foregoing principles, seeRegs. § 1.301-1(f), Example (1).

\textsuperscript{43} SeeRegs. § 1.316-2(b) and (c).

\textsuperscript{44} 89 U. of Pa. L. Rev. 865 (1941).

\textsuperscript{45} 51 Harv. L. Rev. 40 (1937), reprinted with revisions in Paul, Selected Problems
Earnings and Profits. It is a curious fact that the Internal Revenue Code, ordinarily so prodigal in the use of words, nowhere defines the term "earnings and profits," although it has no counterpart in the field of corporation law. The phrase entered the federal tax law in 1916, but until 1940 it was given meaning solely by judicial and administrative construction: In 1940, the effect of a few transactions upon a corporation's "earnings and profits," was prescribed by statute, and Congress has intervened several times since then, but a comprehensive definition is still lacking. To compute the status of a corporation's earnings and profits account is often no simple task, especially when there has been a series of corporate reorganizations or other adjustments. It may be necessary to go back many years to decide how a transaction should have been treated under a now interred statute because of its effect upon earnings and profits.

The computation of "earnings and profits" is not appreciably simplified when we find that, in all probability, the term had little or no meaning to the Congress that invented it. As already mentioned, the phrase first appeared in the Revenue Act of 1916. The Revenue Act of 1913 had taxed "dividends" simpliciter, and by failing to define the term Congress apparently intended to adopt its meaning in common parlance. The Treasury was quick to give it the broadest possible meaning, including among other things distributions from surplus accumulated before the adoption of the Sixteenth Amendment. This construction was upheld by the Supreme Court in Lynch v. Hornby:

Hence we construe the provision of the act that "the net income of a taxable person shall include gains, profits, and income derived from * * * interest, rent, dividends, * * * or gains or profits and income derived from any source whatever" as including . . . all dividends declared and paid in the ordinary course of business by a corporation to its stockholders after the taking effect of the act (March 1, 1913), whether from current earnings, or from accumulated surplus made up

in Federal Taxation (2d Ser., 1938) 149. The Rudick article is supplemented (to 1952) by Albrecht, "Dividends" and "Earnings or Profits," 7 Tax. L. Rev. 157 (1952).

Because corporations ordinarily keep their distributions well under current earnings and profits, it is rarely necessary to ascertain the corporation's earnings and profits with precision, and many questions in the computation of earnings and profits are unanswered for want of litigation. This lamentable obscurity was dispelled to some degree by litigation under the excess profits taxes of World War II and the Korean War, because the corporation's excess profits tax liability depended in part upon its invested capital, which included earnings and profits, thus requiring an accurate determination of the earnings and profits account for some corporations. A number of recent cases in this field stem from fraud investigations: shareholders diverting corporate income in large amounts (e.g., by pocketing the proceeds of cash sales) have litigated the question whether their fraudulent diversions constituted dividend income under § 301(c)(1), returns of capital under § 301(c)(2), or capital gain under § 301(c)(3)(A).

The status of the corporation's earnings and profits account may have to be determined in applying various other provisions of the Code; e.g., § 531 (accumulated earnings tax); § 333 (one-month liquidations).

47 247 U.S. 339 (1918).
of past earnings or increase in value of corporate assets, notwithstanding it accrued to the corporation in whole or in part prior to March 1, 1913. In short, the word "dividends" was employed in the act as descriptive of one kind of gain to the individual stockholder; dividends being treated as the tangible and recurrent returns upon his stock, analogous to the interest and rent received upon other forms of invested capital.48

In the meantime, however, Congress had expressly provided in the Revenue Act of 1916 that:

the term "dividends" as used in this title shall be held to mean any distribution made or ordered to be made by a corporation... out of its earnings or profits accrued since March first, nineteen hundred and thirteen.49

It seems reasonably clear that the term "earnings or profits" crept into the federal income tax law by accident when Congress was establishing March 1, 1913 as a dividing line between taxable distributions and non-taxable distributions. In the first regulations issued under the 1916 Act, the Treasury Department seemingly regarded "earnings and profits" as identical with "surplus."50 It was inevitable, however, that the existence of a corporate surplus could not serve to differentiate between taxable and non-taxable distributions, unless the surplus was first "adjusted" almost beyond recognition. For example, a distribution of common stock by a corporation having only common stock outstanding decreases its surplus, although it does not subject the stockholders to tax;50a if surplus were the criterion of taxability, a corporation could sweep its surplus account clean by a tax-free stock dividend, and then distribute cash free of tax. This might be done even if the distribution of cash would be improper under local law, since in practice and often even by their terms state dividend statutes penalize the stockholders or directors only if creditors are injured by the distribution. Another deficiency in surplus as a criterion of taxability is that it can be reduced by reserves for "contingencies"; if these were taken into account, the floodgates would be opened to a stream of tax-free cash distributions for as long as the corporation's directors could conjure up "contingencies" that would warrant the creation of reserves. It is not surprising, therefore, that surplus has been rejected as a criterion and that the term "earnings and profits" has acquired a meaning more in keeping with its function.

When we search for the meaning of "earnings and profits," then, we are in reality asking how a corporate transaction should affect the stockholder who receives a distribution of cash or property from the corporation after the transaction has occurred. To take a simple illustration, assume that during the first year of a corporation's life

48 247 U.S. at 344.
50 Regs. 33 (revised), Arts. 106-7 (1918).
50a Infra, p. 80.
it earns $10,000, pays a federal income tax of $3,000, and distributes $8,000 to its shareholders. Ignoring other facts, it would probably be agreed that $7,000 should be taxed to the shareholders as a dividend and that the remaining $1,000 should be treated by them as a return of capital.

Not all problems in the computation of earnings and profits, however, are solved so easily. Suppose, in the example just given, the corporation's business earnings amounted to $10,000 but that in addition it had received $500 of tax-exempt interest on state and municipal bonds. Should the $8,000 distribution to the stockholders be treated as a dividend to the extent of $7,500, with only $500 being treated as a return of capital? Or should the bond interest be excluded from earnings and profits as well as from taxable income? One might argue that the interest, which would not have been taxed to the shareholders had they held the bonds in their personal capacities, should not become taxable as income to them merely because it was filtered through the corporate entity; despite this argument, the Regulations have long taken the position that tax-exempt bond interest increases earnings and profits, presumably on the theory that the corporation's capital is not invaded by a distribution of such income.\(^51\) On the same theory, apparently, the Regulations provide that depletion on mines and oil and gas wells must be based on cost (or on March 1, 1913 value) in computing earnings and profits, even though percentage depletion is used in computing taxable income.\(^52\) Thus, if the corporation's earnings are $10,000 computed with the benefit of percentage depletion, but would have been $10,500 had depletion been based on cost, and if federal income taxes are $3,000, a distribution of $8,000 would be a "dividend" to the extent of $7,500 and a return of capital to the extent of only $500. Would the result in any of the foregoing cases be altered if the corporation had created a revaluation surplus or deficit by writing the value of its assets up or down to correspond with changes in their market value? Although one might argue for taking such adjustments into account in computing earnings and profits, since the market value rather than the cost of the corporation's assets is what realistically determines whether a distribution invades its capital or not, it is reasonably clear that appreciation or depreciation in value that has not been "realized" in the income tax sense does not affect earnings and profits. A contrary rule would require the Treasury to appraise the assets with each distribution or, at least, with each revaluation by the directors.\(^53\)

It should be apparent by now that a corporation's accumulated

\(^{51}\) Regs. § 1.312-6(b).
\(^{52}\) Regs. § 1.312-6(c).
\(^{53}\) See Commissioner v. Gross, 236 F.2d 612 (2d Cir. 1956).
earnings and profits are not necessarily equal to its surplus (despite occasional loose use of the terms, even in tax cases, as interchangeable), nor are they equal to total taxable income.\footnote{See also Emmanuel, Earnings and Profits: An Accounting Concept? 4 Tax L. Rev. 494 (1949).} There is, however, a distinct relationship between all three; starting with taxable income, for example, one can derive both earnings and profits and surplus by going through the corporation's books and records and adjusting for items and transactions that are treated one way in computing taxable income and another way in computing either earnings and profits or surplus. By a similar process, with surplus as a starting point, one can derive taxable income and earnings and profits; and with earnings and profits as a base, taxable income and surplus can be computed. Indeed, the corporation income tax return contains a schedule on which the taxpayer reconciles his taxable net income with the increase or decrease in surplus for the taxable year. (Form 1120, Schedule M—Reconciliation of Taxable Income and Analysis of Earned Surplus and Undivided Profits.) In a similar manner, the increase or decrease in earnings and profits for the same year should be computed.

Although earnings and profits can be derived by adjustments to surplus, it is more common to start with taxable income, and to the extent that the Internal Revenue Code and Regulations define earnings and profits, both ordinarily take taxable income as the point of departure. The Regulations state, for example, that "the amount of earnings and profits in any case will be dependent upon the method of accounting properly employed in computing taxable income," so that if the corporation computes taxable income on the cash receipts or disbursement basis, it may not use the accrual method for computing earnings and profits.\footnote{Regs. § 1.312-6(a). This requirement of accounting consistency probably applies to such matters as the depreciation method selected under § 167(b) (see Koshland v. Commissioner, 33 B.T.A. 634 (1935)), the rapid amortization of emergency facilities under § 168 (see I.T. 3543, 1942-1 C.B. 111) and of grain-storage facilities under § 169, the accrual of charitable contributions under § 170(a)(2), the deduction of circulation, research and experimental, and soil and water conservation expenditures under §§ 173-175, and the amortization of organizational expenditures under § 248. See also Siegel v. Commissioner, 29 B.T.A. 1289 (1934) (taxpayer computing taxable income by charging off bad debts cannot use reserves for bad debts in computing earnings and profits).}

As to items that are not taken into account in computing taxable income (e.g., federal income and excess profits taxes and fraud penalties), however, there is authority for putting cash basis taxpayers on the accrual basis. Drybrough v. Commissioner, 238 F.2d 735 (6th Cir. 1956); contra, Helvering v. Alworth Trust, 136 F.2d 812 (8th Cir. 1943). See also Stein's Estate v. Commissioner, 25 T.C. 940, 965 (1956) (Acq.), holding that an accrual basis taxpayer's earnings and profits are to be reduced by its liability for federal income taxes and fraud penalties even though contested in amount, a fact that ordinarily prevents an accrual of deductible taxes in computing taxable income under Dixie Pine Products Co. v. Commissioner, 320 U.S. 516 (1944); and Stark v. Commissioner, 29 T.C. 122 (1957), allowing interest on disputed tax liabilities to be deducted year by year in computing earnings and profits, although the interest was deductible in a later year in computing taxable income.
hensive account of the computation of earnings and profits, it may be said that the most important adjustments to convert taxable income into earnings and profits fall into three categories:

1. Certain items excluded from taxable income must be included in computing earnings and profits. Regs. § 1.312-6(b) states that:

Among the items entering into the computation of corporate earnings and profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 61 or corresponding provisions of prior revenue acts.

In referring to "income not taxable by the Federal Government under the Constitution," the Regulations no doubt meant interest on state and municipal obligations (though the constitutional immunity of such interest is far from clear), and the quoted extract is followed by an explicit statement that such interest is taxable when distributed to shareholders as dividends. The reference in the Regulations to "all income exempted by statute" is ambiguous; taken in its broadest sense, it would require all income items excluded from gross income by Part III of Subchapter B to be included in earnings and profits. As will be seen, such a sweeping inclusion of these items cannot be accepted.

Although authority is scant, the leading commentators have agreed with the Regulations in including in earnings and profits the proceeds of life insurance exempt from taxable income under § 101(a), interest on federal, state, and municipal obligations exempt under § 103, and compensation for injuries or sickness exempt under § 104(a). On the other hand, the commentators have thought that gifts and bequests received by a corporation should be excluded from "earnings and profits" as well as from taxable income, partly on the theory that gifts and bequests cannot be "earned" and are not thought of as "profits", partly on the theory that such gratuitous receipts are

55 Of the items in Part III, the following might be received by a corporation: life insurance proceeds under § 101(a); gifts and bequests under § 102; interest on certain governmental obligations under § 103; compensation for injuries or sickness under § 104, see Castner Garage, Ltd. v. Commissioner, 43 B.T.A. 1 (1940) (Acq.); income from discharge of indebtedness under § 108; the value of a lessee's improvements on the lessor's property under § 109; income taxes paid by a lessee corporation under § 110; recovery exclusions under § 111; the proceeds of certain sports programs under § 114 (but if included in earnings and profits, § 114 proceeds would presumably be offset by a charitable contribution, even if in excess of the 5 percent limit of § 170); capital contributions under § 118; and most of the items referred to by § 121.

Note that Regs. § 1.312-6(b) speaks of "all income exempted by statute," so that the foregoing items are within its scope only if they constitute "income." Hence, although capital contributions are excluded from gross income by § 118, the Regulations cannot properly be construed to require their inclusion in earnings and profits, since they can hardly be regarded as "income", at least not if made by shareholders pro rata. See Schweppes v. Commissioner, 8 T.C. 1224 (1947), aff'd per curiam, 168 F.2d 284 (9th Cir. 1948).
not income at all.\textsuperscript{56} The latter theory is not in conflict with the Regulations (which speaks of “income” exempted by statute); but if such receipts are “income” within the Constitution, the commentators’ view that the term “earnings and profits” was not intended by Congress to embrace gifts and bequests conflicts with the long-standing Regulation.

There are, however, a number of items that are “exempted” from taxable income by statute only in the limited sense that income is recognized not at the outset of a transaction but at a later time. An example is income from the discharge of the corporation’s indebtedness; if the corporation exercises its option under § 108 to exclude such income when realized, it must reduce the basis of its assets so that its profit will be reflected in taxable income when the assets are depreciated or sold. The courts have held that earnings and profits are not to be increased when the debt is cancelled, but only subsequently.\textsuperscript{57} This rule can be reconciled with Regs. § 1.312-6(b) by reading the reference to income “exempted by statute” as embracing items that are permanently excluded from income, but not items whose taxable recognition is merely postponed. Similarly, a lessor corporation ought not to be required to increase earnings and profits by the value of improvements made by its lessee when § 109 is applicable; taxable income, and hence earnings and profits, will be greater in later years because the basis of the property will not reflect the lessee’s improvements. On the other hand, Regs. § 1.312-6(b) probably requires an amount excluded from taxable income by virtue of the “recovery exclusion” of § 111 to be included in earnings and profits; this seems proper, at least if the bad debt or other item giving rise to the recovery exclusion served to reduce earnings and profits in an earlier year. Similarly, if excessive depreciation was of no tax benefit, but reduced earnings and profits, earnings and profits ought to be adjusted upward when the property is sold, even though under § 1016(a)(2)(B) the taxpayer is not required to report the recovery of useless excessive depreciation as income.

2. Certain items deducted in computing taxable income may not be deducted in computing earnings and profits. This category, as

\textsuperscript{56} Rudick, supra, at 882; Paul, supra, at 49; Albrecht, supra, at 186. Rev. Rul. 54-230, 1954-1 C.B. 114, states that the excess of life insurance proceeds (from a policy insuring the life of a stockholder) over the aggregate premiums paid is includible in earnings and profits. This would be appropriate if the premiums had not been deducted from earnings and profits, but not otherwise. See infra, p. 62, suggesting that earnings and profits should be reduced by the excess of premiums paid, but disallowed under § 264, over the cash surrender value of the policy. As to bequests, Diebold v. Commissioner, \textsuperscript{53} F.2d 827 (1st Cir. 1951), cert. denied, 343 U.S. 934 (1952); Alabama By-Products Corp. v. U.S., 228 F.2d 958 (5th Cir. 1956).

\textsuperscript{57} Bangor & Aroostook R. Co. v. Commissioner, 193 F.2d 827 (1st Cir. 1951), cert. denied, 343 U.S. 934 (1952).
described by Rudick,58 consists of "artificially created deductions or credits which are allowed for purposes of computing taxable net income, but which do not represent actual expenses or expenditures, i.e., there is no outlay by the corporation for the deductions or credits represented by such items." As already mentioned, in computing earnings and profits, depletion must be based on cost, even though percentage depletion is employed in computing taxable income. Dividends received from another corporation must be included in full in computing the recipient corporation's earnings and profits, without regard to the 85 percent deduction allowed by § 243 in computing taxable income. The net operating loss deduction of § 172 cannot be used to reduce earnings and profits, since it is simply a carryback or carryover of losses that reduced earnings and profits in the year they occurred. The same is true of the capital loss carryover of § 1212.

3. Certain items that cannot be deducted in computing taxable income may be deducted in computing earnings and profits. This category, as described by Rudick,59 "consists of expenses and losses which are not allowed as deductions in computing taxable net income, but which clearly deplete the income available for distribution to the stockholders." They must be deducted in computing earnings and profits to prevent distributions of the corporation's capital from being taxed as "dividends" to the stockholders. A clear example is the corporation's income taxes; another, equally clear, is the dividends paid in earlier years. Another example is the cost (expenses and interest) of earning tax-exempt income; although § 265 provides that these outlays are not deductible in computing taxable income, they deplete the fund available for distributions to stockholders, and the income to which they are allocable is itself included in earnings and profits. The Regulations, inferentially at least, allow the corporation, in computing earnings and profits, to deduct losses, expenses, and interest on transactions with controlling stockholders, as well as the excess of capital loss over capital gain, although these items are not deductible60 in computing taxable income.61 Unreasonable compensation (disallowed under § 162), disallowed charitable contributions (in excess of the 5% ceiling prescribed by § 170(b)(2)), and the excess of life insurance premiums paid, but disallowed as a deduction by § 264) over the cash surrender value of the policy should probably also be deducted in computing earnings and profits.62 Losses on "wash sales" at one time were apparently deductible in computing earnings and profits, but

58 Supra, note 44 at 885.
59 Id. at 887.
60 §§ 267 and 1211.
61 Regs. § 1.312-7(b)(1), fourth sentence.
62 See the stipulated computation of earnings and profits in Stark v. Commissioner, 29 T.C. 122 (1957).
§ 312(f)(1) now provides to the contrary, in recognition of the fact that the losses will be taken into account in computing both taxable income and earnings and profits at the time the investment is finally closed out. Other losses on the sale or other disposition of property, if unrecognized in computing taxable income, are to be similarly disregarded in computing earnings and profits, since they will normally be taken into account at a later date.63

Earnings and profits should probably also be adjusted for certain other corporate outlays that are not deductible in computing taxable income, such as lobbying expenses and political contributions;64 there is little reason to think that Congress would have wanted such items to be disregarded in determining whether a distribution to stockholders came out of earnings or capital. More doubtful, however, is the proper treatment of expenses that are disallowed in computing taxable income on grounds of public policy, such as fines, bribes, overceiling price and wage payments, and the like, as well as contributions to organizations engaged in "prohibited transactions" or subversive activities.65 Although these items might be classed with penalties for federal income tax fraud, which have long been allowed by the Internal Revenue Service itself as deductions in computing earnings and profits (though with some quibbling about the proper year),66 the subject will have to be reconsidered as a result of the Supreme Court's decision in Tank Truck Rentals, Inc. v. Commissioner,67 Hoover Motor Express Co., Inc. v. United States,68 and Commissioner v. Sullivan.69 These cases might be distinguished as resting on the "ordinary and necessary" qualification of § 162; statutory language aside, the spirit of Sullivan is hospitable, and that of Tank Truck Rentals, Inc. and Hoover Motor Express Co., Inc. hostile, to the theory that earnings and profits should be reduced by any outlays that reduce the corporation's economic capacity to make distributions, even though this may reduce the incentive to comply with state or federal law.

63 § 312(f)(1).
64 Cammarano v. United States, 246 F.2d 751 (9th Cir. 1957), cert. gr., 355 U.S. 952; § 271.
65 See § 170(d).
66 Rev. Rul. 57-332, 1957-2 C.B. 231. But see Bernstein v. United States, 234 F.2d 475 (5th Cir. 1956): "... it is not consistent with our ideas of proper accounting practice for officers and directors of a corporation to be permitted to conduct the affairs of their corporation in such a way as to defraud the government and then assert the existence of a fraud penalty as a corporate liability, and thus translate what would otherwise be a dividend distribution to themselves into a distribution of capital." Although the tone of these remarks implies that the fraud penalties should never be allowed to reduce earnings and profits, the reference to "proper accounting practice" suggests that earnings and profits may be reduced if and when the fraud penalties are assessed or paid.
In addition to the foregoing adjustments to taxable income, the calculation of earnings and profits must take account of a great variety of financial transactions that may occur only occasionally in the life of any one corporation. Among these transactions, some of which are discussed elsewhere herein, are the following:

1. The receipt by the corporation of tax-free distributions from other corporations, such as stock dividends,\(^70\) non-dividend distributions of cash and property,\(^71\) etc.
2. Distributions by the corporation in kind\(^72\) or of its own stock\(^73\) or obligations.\(^74\)
3. Distributions by the corporation in partial liquidation or in redemption of its stock.
4. Distributions by the corporation of the proceeds of a loan insured by the United States.\(^75\)
5. Mergers, consolidations, liquidations, transfers of property, spin-offs, and other transactions by which one corporation succeeds to the assets or tax history of another.

**B. Distributions in Kind**

Introductory. When a corporation distributes cash to its shareholders, the tax consequences to both the recipient and his corporation can be easily determined if the corporation's earnings and profits are known. The distribution is a "dividend" to the extent of the corporation's current and accumulated post-1913 earnings and profits; the balance, if any, is applied against and reduces the adjusted basis of the shareholder's stock under § 301(c)(2); and any excess is subject to § 301(c)(3). The shareholder, having received cash, has no problem. As to the corporation, the distribution itself is not a taxable event; and its earnings and profits are reduced to the extent that the distribution is a "dividend" to the shareholders.

When we turn from a corporate distribution of cash to a distribution in kind,\(^76\) however, the problems quickly proliferate. Does the mere distribution of appreciated property create corporate income or earnings and profits? Does the distribution of depreciated property produce a corporate loss? If not, is a prompt sale of appreciated or depreciated property by the distributees to be treated as a corporate transaction, so that the gain or loss will be imputed to the corporation? Is a distribution of property "out of" current or post-1913 earnings and profits (and hence a "dividend") if they exceed its adjusted basis?

\(^70\) Infra, p. 80.
\(^71\) Supra, p. 54.
\(^72\) Infra, p. 64.
\(^73\) Infra, p. 80.
\(^74\) Infra, p. 78.
\(^75\) See § 312(j).
\(^76\) The term "distribution in kind" is used here to mean a distribution of property other than money or the distributing corporation's own stock or obligations.
but are less than its fair market value? Are the corporation's earnings and profits to be reduced by the fair market value of the distributed property, or by its adjusted basis? What is the basis of the distributed property in the hands of the shareholders?

Before the 1954 Code was enacted, these questions engaged the attention of the most acute commentators on the federal income tax. Their answers were far from unanimous, and the judicial opinions were unusually unsatisfactory. Many of the disputed issues have been settled by the 1954 Code, however, so the status of pre-1954 distributions will be discussed hereafter only as background to the new rules.

Section 311(a)(2), enacted in 1954, provides (with three exceptions) that the corporation shall not recognize gain or loss on a distribution in kind. This is a statutory acceptance of a pre-1954 judicial rule; despite the Treasury's persistent contention that the distribution of appreciated property should be treated by the corporation as a taxable occasion (just as though it had sold the property or used it to discharge a debt), the lower courts uniformly held that the mere distribution of appreciated property did not produce corporate gain or loss. For this principle, they ordinarily cited General Utilities & Operating Co. v. Helvering. In fact, although the government had argued for the recognition of taxable income upon a distribution of appreciated property in the General Utilities & Operating Co. case, the Supreme


Significant early contributions were: Paul, Ascertainment of "Earnings or Profits" for the Purpose of Determining Taxability of Corporate Distributions, in Selected Studies in Federal Taxation (2nd Ser., 1938) 149, 167-185; Johnson, Corporation and Stockholder—Dividends in Kind, 1 Tax L. Rev. 86 (1945); Wallace, A Dissent, ibid. 93.

78 296 U.S. 200 (1935). See Beach Petroleum Corp., Ltd. v. Commissioner, ¶ 46,192 P-H Memo TC; Molloy, supra, at 60, n.20.

79 The government's argument on this point was as follows:

... In making it [the appreciation] available to its own stockholders the corporation is realizing the appreciation, and nothing more is necessary. It is our view that the addition to surplus on account of the increased value and the distribution of this increased value in satisfaction of the company's general liability to its stockholders, are the evidence that the gain has been realized, for it is incomprehensible how a corporation can distribute to its stockholders something which it has not itself received. ... It is clear that petitioner used the increased value for a corporate purpose, and was thereby enabled to pay its stockholders $1,071,426.25. Thus was petitioner serving the principal end for which it was organized—to earn profits which it would distribute to its stockholders—and we submit that in so justifying the hopes of its organizers this economic entity, called a corporation, truly derived an economic gain. (Respondent's brief, pp. 18, 25.)

The Supreme Court refused to consider this issue, which was not raised below; the only government argument it noticed was that the corporation's dividend resolu-
Court did not find it necessary to pass on this issue; but even though the question was not foreclosed by that case, the result reached by the lower courts was endorsed, at least for the future, by the enactment in 1954 of § 311(a)(2).

Section 311(a)(2) is applicable, however, only if the corporation makes a distribution of property "with respect to its stock." The Regulations state:

Section 311 does not apply to transactions between a corporation and a shareholder in his capacity as debtor, creditor, employee, or vendee, where the fact that such debtor, creditor, employee, or vendee is a shareholder is incidental to the transaction.\(^8^0\)

See also the Senate Report on the 1954 Code, which states:

Your committee does not intend, however, through [§ 311(a)(2)] to alter existing law in the case of distributions of property, which has appreciated or depreciated in value, where such distributions are made . . . to shareholders in a capacity other than that of a shareholder. For example, distribution of property made to a shareholder in his capacity as a creditor of the distributing corporation is not within the rule of [§ 311(a)].\(^8^1\)

Before 1954, there were several cases in which a corporation realized gain or loss on the distribution of appreciated or depreciated property to its shareholders, because the resolution authorizing the distribution created an obligation in terms of money. In *Bacon-McMillan Veneer Co. v. Commissioner*,\(^8^2\) for example, the dividend resolution provided for a "fifty per cent dividend" [evidently 50 percent of the stock's par value], "payable in Liberty Loan bonds in denominations of $1,000.00 each, at their market value this date," with odd amounts to be paid in cash. The court held that the corporation realized income when it used the bonds (the value of which exceeded their adjusted basis) to defray the indebtedness created by the dividend resolution:

The resolution provided that a 50 per cent dividend be declared. A 50 per cent dividend is a definite amount. It created an obligation of the corporation to its stockholders. Then when that obligation was satisfied by the distribution of the Liberty bonds owned by the [corporation], we have a realization of a gain through disposition thereof. When the dividend of 50 per cent was declared the corporation could not satisfy the legal demands of the stockholders by delivering to them bonds less than that value. The corporation discharged its obligation to its stockholders, which was satisfied by the use of appreciated property. It has been argued that in rejecting this argument, the Court must have assumed a fortiori that the mere distribution of the appreciated property was not a taxable event, but there is a big difference between answering a question and assuming an answer in the absence of timely argument.

\(^8^0\)Regs. § 1.311-1(e)(1).

\(^8^1\)S. Rept. No. 1622, 83d Cong., 2d sess., p. 247.

\(^8^2\)20 B.T.A. 556 (1930).
holders by giving them the bonds which here had a value in excess of the cost. We think that this is a realization of gain in every substantial sense of the word.\textsuperscript{83}

See also \textit{Callanan Road Improvement Co. v. Commissioner}.\textsuperscript{84} The status of these cases is not entirely clear under the 1954 Code. It is at least arguable that the distribution is made to the shareholder "with respect to his stock" (so as to invoke the non-recognition rule of § 311(a)), even though he is also a creditor of the corporation.\textsuperscript{85} But it is by no means sure that the pre-1954 cases were to be overruled by the enactment of § 311(a), and these cases might be preserved on the ground that it is not the distribution, but the satisfaction of the debt, that produces gain or loss. The issue can ordinarily be avoided, if the property has appreciated in value, by a dividend resolution referring only to the property; if there is no indebtedness measurable in dollars, the \textit{Bacon-McMillan Veneer Co.} rationale is inapplicable.\textsuperscript{86} If the property has depreciated in value, on the other hand, the corporation may find it feasible to realize a deductible loss by selling the property and distributing only the proceeds to its shareholders.

There are three statutory exceptions to the general rule of § 311(a):

1. On a distribution of LIFO inventory, § 311(b) requires the distributing corporation to recognize gain to the extent (if any) that the LIFO value is less than the basis determined by a non-LIFO method. (Ordinarily this would be FIFO, although the taxpayer apparently has some range of choice, since § 311(b)(1)(A) speaks merely of "a" method authorized by § 471.) The difference between the LIFO and non-LIFO values is thus belatedly taken into income.

2. On a distribution of property that is subject to a liability, or in connection with the distribution of which the shareholder assumes a liability, § 311(c) requires the corporation to recognize gain to the extent that the liability exceeds the adjusted basis of the property. (If the liability is not assumed, the gain to be recognized by the corporation may not exceed the excess of the value of the property over its adjusted basis.) In effect, the distribution is treated as a sale of the property for the amount of the liability, with the proceeds being applied to satisfy the liability for which the corporation is now only secondarily liable. The statute does not expressly so state, but presumably if the liability is not paid by the shareholder or satisfied by the property by which it

\textsuperscript{83} 20 B.T.A. at 559.

\textsuperscript{84} 12 B.T.A. 1109 (1928) (loss on distribution of depreciated property); Mintz and Plumb, supra, at 44, n.15, and 53-4.

\textsuperscript{85} The narrow statutory ground of Rev. Rul. 55-410, 1955-1 C.B. 297 (holding that the satisfaction of a charitable pledge, made in a dollar amount, with appreciated or depreciated property does not produce gain or loss), distinguishes it from the dividend resolution cases, but its spirit is hostile to the recognition of gain or loss.

\textsuperscript{86} See Natural Gasoline Corp. v. Commissioner, 219 F.2d 682 (10th Cir. 1955) (ambiguous resolution construed as property distribution); General Utilities & Operating Co. v. Helvering, supra.
is secured, and if the corporation is compelled to pay off the debt, it will have a deductible loss or bad debt.\textsuperscript{87}

3. On a distribution of installment obligations, §§ 311(a) and 453(d) require the corporation to recognize gain or loss to the extent of the difference between the basis of the obligation and its fair market value at the time of distribution.

A major uncertainty in the scope of § 311(a) was created by the statement in the Senate Report on the 1954 Code that "your committee does not intend to change existing law with respect to attribution of income of shareholders to their corporation as exemplified for example in the case of \textit{Commissioner v. First State Bank of Stratford}.\textsuperscript{87a} That case was concerned with the tax consequences of a distribution by a bank to its shareholders of certain notes that it had written off as worthless in earlier years. Despite the write-offs, the notes were thought at the time of distribution to be collectible in part. They were endorsed by the bank (without recourse) to one of its employees, who proceeded to make collections on them as though they were still owned by the bank, except that the proceeds were deposited in a special account for the benefit of the shareholders. The court held that the collections were income to the bank, but the basis of the opinion is far from clear. One thought running through it is that the bank’s enjoyment of a tax benefit from writing the notes off as worthless carried with it an obligation to report any later recoveries as taxable income. But the court also suggested that the bank was taxable on the broader theory that the distribution itself was an anticipatory assignment of income, comparable to the gift of bond coupons in \textit{Helvering v. Horst}.\textsuperscript{88}

Even though the bank never received the money, it derived money’s worth from the disposition of the notes which it used in place of money in procuring a satisfaction that was procurable only by the expenditure of money or money’s worth. The enjoyment of the economic benefit was realized as completely as it would have been if the bank had collected the notes in dollars and cents and paid the money as a dividend to its shareholders. . .

The acquisition of profits for its shareholders was the purpose of its creation. The collection of income on loans was a principal source of its income. The payment of dividends to its shareholders was the enjoyment of its income. A body corporate can be said to enjoy its income in no other way. Like the "life-rendering pelican," it feeds its shareholders upon dividends.\textsuperscript{89}

This portion of the opinion seems to mean that the corporation must recognize income on the distribution of any property with a value

\textsuperscript{87} See the analogous treatment of liabilities in excess of basis by § 357(c).
\textsuperscript{87a} 168 F.2d 1004 (5th Cir. 1948), cert. denied, 335 U.S. 867.
\textsuperscript{88} 311 U.S. 112 (1940).
\textsuperscript{89} 168 F.2d at 1009.
greater than its basis, at least if the shareholders thereafter sell the property or otherwise realize income from it. Moreover, the court's reasoning comes perilously close to the argument of the government in the General Utilities & Operating Co. case, that a distribution of appreciated property is itself a taxable realization by the corporation of the increase in value, even if the property is not thereafter sold by the shareholders. 90

Since the Senate Report, quoted above, states that the Stratford Bank case is only an "example" of the existing law which is left undisturbed by § 311(a), we must cope with the possibility that there are other examples of the "attribution of income of shareholders to their corporation." The Court Holding Co. case 91 is a classic example of this doctrine; there a corporation was about to sell an appreciated apartment house, but the corporate negotiations were called off at the last minute in favor of a liquidation, followed by a sale of the property by the shareholders. The Supreme Court upheld the Tax Court's determination that the corporation was taxable on the profit from the sale of the property, although the sale was in form made by the shareholders:

A sale by one person [the corporation] cannot be transformed for tax purposes into a sale by another by using the latter as a conduit through which to pass title. . . . [T]he executed sale was in substance the sale of the corporation. 92

Nothing in § 311(a), providing that the corporation shall not recognize gain or loss on the "distribution" of property, undercuts the theory of the Court Holding Co. case, under which income is attributed to the corporation not because of the distribution, but because of a factual determination that the sale by the shareholders "was in substance the sale of the corporation." The Court Holding Co. doctrine has been somewhat limited by United States v. Cumberland Public Service Co., 93 but its heart is still intact, unimpaired by the enactment of § 311(a).

Another example of pre-1954 law on the attribution of shareholder income to the corporation is United States v. Lynch, 94 requiring a corporation to report income realized by its shareholders on the sale of fruit that had been distributed to them as a dividend in kind. The fruit was part of the corporation's inventory; after the distribution, the corporation on behalf of the shareholders proceeded to market the fruit in its customary manner, except that it acted on behalf of the shareholders rather than on its own account. The court said:

90 Supra, note 79.
91 324 U.S. 331 (1945).
92 324 U.S. at 334.
94 192 F.2d 718 (9th Cir. 1951), cert. denied, 343 U.S. 934 (1952).
The dividend in question was not the kind of a distribution contemplated by the statute, . . . and must be ignored for tax purposes. Distribution of corporate inventory with the expectation of immediate sale by the shareholders pointedly suggests a transaction outside the range of normal commercially-motivated and justifiable corporate activity, yet we have here a stronger case, because the sale was to be made by utilizing the corporation’s facilities in the ordinary course of its business; the shareholders did not engage in a separate and independent business in which the apples were to be used.95

The court in the Lynch case relied heavily on Commissioner v. Transport Trading & Terminal Corp.,96 where the Court of Appeals for the Second Circuit indicated that it might go so far as to attribute the profit on a sale to the corporation even if there had been no corporate negotiations or use of corporate selling facilities and even if non-inventory property was involved, merely because the distribution served no non-tax function and was made in the expectation that the distributee would sell the distributed property.

It seems likely, then, that in preserving “existing law with respect to attribution of income of shareholders to their corporation,” the 1954 Code requires the corporation to report not only the kind of income involved in the Bank of Stratford case, i.e., the proceeds of property with a zero basis the cost of which was previously written off with tax benefit. The corporation can probably also be taxed under the Court Holding Co. doctrine, where a corporate transaction is called off at the last minute; under the Lynch case, where inventory property is distributed and corporate facilities are thereafter employed to market the property in the usual manner;97 and possibly also under the Transport & Trading Corp. theory, where a sale by the distributee is expected and the distribution serves no non-tax purpose.98

The foregoing discussion has centered on the attribution of taxable gain to the corporation. If the property has depreciated in value, and is sold by the distributees for less than its adjusted basis to the corpo-

95 192 F.2d at 720.
96 176 F.2d 570 (2d Cir. 1949), cert. denied, 338 U.S. 995 (1950).
97 § 311(b), providing that the excess of non-LIFO value over LIFO value is taxable to the corporation at the time of distribution, does not stand in the way of attributing income to the corporation on a later sale of the property by the shareholders. The profit at that time would be calculated on the non-LIFO value. Since the Senate Report refers to the “attribution of income,” however, it is not clear whether a loss could be claimed by the corporation if the sales price were less than the non-LIFO value.
98 In the liquidation area, the Cumberland Public Service Co. case, cited in the text, conflicts with the spirit of the Transport & Trading Corp. case, since the former honors a liquidating distribution for the sole purpose of enabling the distributees to sell the property. But it is less clear that the same respect would be paid to a tax-motivated distribution by a going concern; there is a hint to this effect in the Court’s statement in Cumberland that “[t]he corporate tax is thus aimed primarily at the profits of a going concern.” 338 U.S. at 455. Moreover, a liquidation, whatever its motivation, has non-tax consequences that do not flow from a non-liquidating distribution.
ration, can the corporation claim a loss on the ground that there was "really" a sale by it? Although there appear to be no cases in point, the *Court Holding Co.* case might be applied in appropriate circumstances, unless the courts are prepared to hold that the taxpayers must stand by the form of their transaction even if the government is not bound by it. Ordinarily the shareholders would seek to avoid the issue by having the corporation sell any depreciated property in its own name. Such a transaction in its turn might be attacked by the government with still another variation on the *Court Holding Co.* theme: if a plan to distribute depreciated property was "called off" at the last moment after the shareholders had arranged for a sale, a purported sale by the corporation followed by a distribution of the proceeds might be regarded as "in substance" a distribution of the property itself coupled with a sale by the shareholders. Viewed as a shareholder transaction, the sale would not give rise to a deduction by the corporation.

*Taxability of distribution to individual distributees.* The tax on the recipient of a distribution in kind depends, by virtue of a 1954 change in the Internal Revenue Code, upon whether the recipient is a corporation or an individual (including estates, trusts, and other noncorporate taxpayers).

To take first the case of a noncorporate distributee,\(^99\) if the value of the distributed property is fully covered by the corporation's current or post-1913 earnings and profits,\(^100\) the distribution is a taxable "dividend" to the extent of its fair market value, under §§ 301(b)(1)(A), 301(c), and 316.\(^101\) If the value of the distributed property exceeds the corporation's current and post-1913 earnings and profits, however, the Regulations state that the distribution is a "dividend" only to the extent of the earnings and profits.\(^102\) The balance would reduce the basis of the distributee's stock under § 301(c)(2), with any excess over basis being subject to § 301(c)(3). The Regulations illustrate the principle that the distribution is a

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\(^99\) For the taxability of corporate distributees, see infra, p. 74.
\(^100\) Supra, p. 52.
\(^101\) § 301(b)(1)(A) provides that, in the case of a noncorporate distributee, the "amount" of a distribution in kind is its fair market value, adjusted under § 301(b)(2) for liabilities assumed by the shareholder or to which the distributed property is subject. By virtue of § 301(b)(3), fair market value is to be determined "as of the date of the distribution." This date may differ from the date when the distribution is includible in gross income, according to Regs. § 1.301-1(b). (But query whether, if the date of inclusion in gross income precedes the date of distribution and if the property increases in value between the two dates, the higher value can be included in computing income on the earlier date.) Note also that a distribution may become a "dividend" by virtue of earnings and profits arising during the taxable year but after the date of distribution. § 316(a)(2).
\(^102\) Regs. § 1.316-1(a)(2).
“dividend” only to the extent of the corporation’s earnings and profits in the following way:

**Example.** X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is $5,000.\(^{103}\)

The issue that is so calmly resolved by this example was heatedly debated under both the 1939 and 1954 Codes; and the debate is not yet over. Even a recapitulation of the debate under the 1939 Code would be too lengthy, so we must content ourselves here with saying that the two principal competing views were: (a) That a shareholder could never be required to report more dividend income than his pro rata share of the corporation’s earnings and profits, as in the above example from the 1954 Regulations; and (b) That a distribution of appreciated property was taxable to the extent of its fair market value, if its adjusted basis was fully covered by earnings and profits, so that in the example given the shareholders should each recognize $8,000 of dividend income. A third, and bolder, thesis was that a distribution was a “dividend” to the shareholders unless it impaired the corporation’s capital, so that the appreciation in value of the distributed property was taxable even if the corporation had no earnings and profits.\(^{104}\) As might be expected when the views of acute commentators are so divergent, neither side could find more than tenuous support in the 1939 Code, and for some time the judicial decisions were meager both in number and in persuasive power. After the House of Representatives had passed its version of the 1954 Code, however, the Courts of Appeals for the Second and Third Circuits decided the Hirshon Trust and Godley cases (involving different shareholders of the same corporation) and held (under the 1939 Code) that the full fair market value of appreciated property was taxable to the shareholders if the corporation’s earnings and profits were sufficient to cover the adjusted

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\(^{103}\) Regs. § 1.316-1(a)(3), Example.

\(^{104}\) The first view was espoused by Molloy, supra, at 69-70; the second, by the government, see Mintz and Plumb, supra, at 58-9; and the “capital impairment” theory, by Raum, supra, at 613. A variation on the “capital impairment” theory is that the appreciation in value does not come from either earnings and profits or capital, and is taxable under the catch-all phraseology of § 22(a) of the 1939 Code (now, with revisions in language, § 61 of the 1954 Code); this argument was advanced by the government and rejected by the court in Cloutier v. Commissioner, 24 T.C. 1006, 1015 (1955) (Acq.). A fourth theory, which virtually all commentators found too bizarre for acceptance, was that the distribution was fully taxable if the property had been purchased “with” earnings and profits (i.e., purchased at a time when the corporation had earnings and profits), without regard to the earnings and profits account at the time of distribution. See Commissioner v. Wakefield, 139 F.2d 280 (6th Cir. 1943).
basis of the property.\textsuperscript{105} The theory of these cases is not free from doubt, but apparently the judges started with the proposition that earnings and profits should be reduced by the adjusted basis of the distributed property and inferred therefrom (a) that so far as the corporation was concerned the distribution was a "dividend" in its entirety if its adjusted basis was covered by earnings and profits, and (b) that the term "dividend" should mean the same thing to the distributees as to the distributing corporation.\textsuperscript{106}

The language of the 1954 Code is not quite the same as the 1939 Code, on which the Hirshon and Godley's Estate cases rest, and it has been ingeniously argued that the 1954 changes destroy the basis of those cases;\textsuperscript{107} but if the draftsmen really intended a change, they could hardly have concealed their purpose more successfully. Despite the similarities between the two statutes, however, the House and Senate Reports on the 1954 Code both express the view (contrary to the result in Hirshon and Godley's Estate) that the shareholders realize dividend income on the distribution of appreciated property only to the extent of the corporation's earnings and profits.\textsuperscript{108} Although it is difficult to find a statutory basis for these committee statements,\textsuperscript{109}

\textsuperscript{105} Commissioner v. Hirshon Trust, 213 F.2d 523 (2d Cir. 1954), cert. denied, 348 U.S. 861; Commissioner v. Godley's Estate, 213 F.2d 529 (3d Cir. 1954), cert. denied, 348 U.S. 862. The Tax Court, after exhaustively reviewing the legislative history of the 1939 Code in the light of these cases, however, adhered to its earlier view that the distribution can be a "dividend" only to the extent of the corporation's earnings and profits. Cloutier v. Commissioner, supra, note 104.

\textsuperscript{106} It is debatable whether the courts accepted the full-blown capital impairment theory; it would require the appreciation in value to be taxed as a "dividend" to the shareholders whether the corporation had earnings and profits or not, and at points both courts relied upon a construction of the statute that would permit the appreciation to be taxed in full only if the property's adjusted basis was covered by earnings and profits. If so, the corporation in the Hirshon Trust and Godley cases could have reduced its shareholders' taxable income by increasing its distribution. It distributed about $2 million in cash and property worth about $9 million when its earnings and profits amounted to about $5.7 million. By distributing $5.7 million in cash (instead of $2 million), the corporation could have wiped its earnings and profits account clean, so that (on the foregoing hypothesis), a later distribution of the property would have been a return of capital. By increasing its distribution from $11 million to $14.7 million, then, the corporation would have reduced its shareholders' dividend income from $11 to $5.7 million!

\textsuperscript{107} Mintz and Plumb, A Postscript, supra, n.77. As they say (at 72, n.154), it is hard "to find the change on the face of the statute, except by some close semantic reasoning."

\textsuperscript{108} H. Rept. No. 1337, 83d Cong., 2d sess.; p. A94; S. Rept. No. 1622, ibid., p. 248. The Senate Report disclaims "any implication . . . with respect to the effects of a distribution of property on earnings and profits and on the shareholders under the 1939 Code." In 1956, Congress retroactively amended the 1939 Code to provide, in general, that a distribution of appreciated property was a "dividend" only to the extent of earnings and profits, thus applying the 1954 rule (as set out in the regulations) to pre-1954 years and rejecting the contrary rule of the Hirshon Trust and Godley cases. § 115(n), 1939 Code.

\textsuperscript{109} The Treasury's proposed regulations adhered to the result in Hirshon and Godley's Estate, despite the position of the committee reports. Proposed Regs. § 316-1(a)(2)
the statute is sufficiently ambiguous to tolerate them, and the validity of the Regulations quoted earlier in this section, if attacked, will probably be upheld.

In the example used above, the corporation’s earnings and profits exceed the adjusted basis of the property. If the earnings and profits were only $5,000 (instead of $10,000), each shareholder would have dividend income of only $2,500, and would treat the remaining $5,500 of his distribution as a return of capital.

If the corporation distributes depreciated property, the governing principles are the same: to the extent of the earnings and profits, the fair market value of the property is a dividend; the balance, if any, is a return of capital, subject to §§ 301(c)(2) and (3).

The distributee’s basis for the distributed property is its fair market value, determined as of the date of the distribution.

**Taxability of distribution to corporate distributees.** The status of a corporate distributee receiving a distribution in kind is complicated by § 301(b)(1)(B), which provides that the “amount” of a distribution to such a distributee is the property’s fair market value (determined as of the time of the distribution) or its adjusted basis in the hands of the distributing corporation, whichever is the lesser. The purpose of this restriction (applicable only to corporate distributees) may be illustrated by an example. Assume that the fair market value of the distributed property is $50,000, that its adjusted basis in the hands of A (the distributing corporation) is $10,000, that A has $50,000 of earnings and profits, and that A is wholly owned by B, another corporation. Were it not for § 301(b)(1)(B), B would have $50,000 of dividend income on receiving the property from A, but by virtue of the 85 percent deduction for intra-corporate dividends provided by § 243(a), only $7,500 would be subject to tax. At trivial tax cost, then, B would obtain a $50,000 basis for computing depreciation and gain or loss on the distributed property. Section 19 Fed. Reg. 8253 (Dec. 11, 1954). In their final form, however, the Regulations accepted the theory of the committee reports. Regs. § 1.316-1(a)(2) and (3).

The author has elsewhere suggested that the committee reports may have been based on a misapprehension of the Hirshon and Godley’s Estate cases. Bittker, Stock Dividends, Distributions in Kind, Redemptions and Liquidations Under the 1954 Code, 1955 So. Calif. Tax Inst. 349, 366-7.

110 Supra, p. 72.

111 § 301(d)(1); see supra, note 101.

112 The distributing corporation’s adjusted basis is to be increased by any gain recognized to it under § 311(b) (relating to certain LIFO inventory) or 311(c) (relating to certain liabilities in excess of basis), supra, p. —. It is not clear why § 301(b)(1)(B) does not provide a similar adjustment for any gain recognized by the distributing corporation under §§ 311(a) and 453(d) (relating to the distribution of installment obligations).

If the distributee assumes any liability in connection with the distribution, or receives the distributed property subject to any liability, the “amount” of the distribution must be reduced by virtue of § 301(b)(2).
301(b)(1)(B) avoids this result, with its attendant possibilities for manipulation, by providing that the "amount" of the distribution to B is only $10,000, the property's adjusted basis to A.\textsuperscript{113}

Having determined the "amount" of a distribution under § 301(b)(1)(B), the distributee corporation must report that part which is covered by earnings and profits as a dividend and the balance, if any, as a return of capital subject to §§ 301(c)(2) and (3).

The corporate distributee's basis for the distributed property is the same as the "amount" of the distribution, viz., the property's fair market value (determined as of the time of the distribution) or its adjusted basis in the hands of the distributing corporation, whichever is the lesser. If the distributee carries over the basis of the distributing corporation, it will also be entitled to "tack" that corporation's holding period, under § 1223(2).

If a corporation has both corporate and noncorporate shareholders, its choice of property for distribution may affect the tax returns of the shareholders. Assume that A Corporation owns two parcels of property, each worth $50,000, but with adjusted bases of $10,000 and $90,000 respectively. Assume also that A has $100,000 of earnings and profits and is owned equally by B, another corporation, and C, an individual. If the first parcel is distributed to B, its dividend income and basis for the property will be $10,000. If the second parcel is distributed to B, however, it will have dividend income, and a basis, of $50,000. For C, the choice is immaterial; the distribution of either parcel to him will result in dividend income, and a basis, of $50,000. A Corporation, therefore, can benefit B by distributing either the low or high basis property to it (depending upon whether the added tax cost to B of receiving the high basis property is outweighed by the attainment of a stepped-up basis), without prejudice to C, the individual shareholder. The Commissioner might assert, however, that "in reality," A distributed a 50 percent interest in each parcel to B and C, and that B and C thereafter rearranged their interests. If the distribution is "realigned" in this fashion, the taxability of the distribution would be altered, and it is also possible that the theoretical exchange between B and C would be a taxable event, unless it could be brought within a non-recognition provision, such as § 1031(a).

Distributions in kind: Effect on earnings and profits. Upon a distribution in kind, the corporation's earnings and profits must be adjusted to reflect the decline in its asset position.

I. General rule. Section 312(a) states as a "general rule" that

\textsuperscript{113} Another statutory approach to this problem was in effect from 1950 to 1954; § 26(b) of the 1939 Code limited the dividends received credit to 85 percent of the distributing corporation's basis for the property. See H. Rept. No. 2319, 81st Cong., 2d sess., reprinted in 1950-2 C.B. 380, 418.
earnings and profits shall be decreased by the adjusted basis of the distributed property. If a corporation with post-1913 accumulated earnings and profits of $15,000\(^{114}\) distributes property with an adjusted basis of $5,000 and a fair market value of $10,000 to Jones, its sole stockholder, he must report dividend income in the amount of $10,000, but the corporation's earnings and profits will be reduced by only $5,000, leaving $10,000 of its earnings and profits for future distribution. A later distribution of $15,000 in cash, therefore, would result in $10,000 of dividend income plus a $5,000 reduction in the basis of Jones' stock. The tax consequences of the two distributions would be drastically altered if their order were reversed. An initial distribution of $15,000 in cash would constitute a dividend to Jones in the amount of $15,000 and would wipe the corporation's earnings and profits account clean. A later distribution of the property, therefore, would not be a "dividend" to any extent; instead, it would result in a $10,000 reduction in the basis of Jones' stock.

Timing is also critical if the distributed property is worth less than its adjusted basis. If the adjusted basis of the distributed property in the example just outlined had been $15,000 (instead of $5,000), earnings and profits would be reduced by $15,000 on a distribution of the property, even though Jones' dividend amounted to only $10,000, the value of the distributed property. Thus, a $10,000 "dividend" in kind would sweep the earnings and profits account clean, so that a later distribution of $15,000 in cash would be applied to reduce the basis of Jones' stock, rather than taxed as a "dividend." Had the cash been distributed before the property, however, Jones would have had $15,000 of dividend income and a $10,000 basis reduction on the two distributions.

2. Certain inventory assets. A special rule is provided by § 312(b)(1) to govern the adjustment of earnings and profits if the corporation distributes "inventory assets" with a fair market value in excess of their adjusted basis.\(^{116}\) (The term "inventory assets" is defined to mean not only stock in trade and other property properly includible in inventory, but also property held primarily for sale to customers in the ordinary course of the corporation's trade or business and certain "unrealized receivables or fees").\(^{116}\) On a distribution of

\(^{114}\) In the calculations that follow, it is assumed that the corporation has post-1913 accumulated earnings and profits, against which distributions are charged in chronological order, rather than earnings and profits of the taxable year, which are apportioned among all distributions in that year. Supra, p. 55; see Regs. § 1.316-2(b) and (c). These Regulations, in point of fact, illustrate the method of allocation only for cash distributions, but probably a similar method would be employed for property distributions. See W. G. McGuire & Co. v. Commissioner, 20 T.C. 20 (1953).

\(^{115}\) The Regulations do not state whether fair market value is to be computed at wholesale or at retail, what adjustments, if any, are to be made for anticipated selling costs, etc.

\(^{116}\) § 312(b)(2).
such "inventory assets," the corporation must (a) increase its earnings and profits by the excess of their fair market value over their adjusted basis, and (b) decrease earnings and profits (but not below zero) by the fair market value of the assets.

Congress has not been willing to require the corporation to recognize taxable income on the distribution of appreciated assets (except to a limited degree), but on the other hand, it was not willing to give "inventory assets" the same treatment as other property, where the distribution produces neither taxable income nor earnings and profits. In effect, Congress has put "inventory assets" in an intermediate category, whose distribution will produce earnings and profits but not taxable income. This will insure that the corporation will have at least enough earnings and profits to cover the appreciation in value, so noncorporate distributees will always have to report at least this amount as dividend income, unless the earnings and profits created by § 312(b) are offset by losses. The shareholders of a corporation, therefore, will be unable to get a "cheap" stepped-up basis for distributed "inventory assets," even if the corporation has no earnings and profits when the distribution is arranged; the distribution itself will create enough earnings and profits to cover the appreciation in value, and noncorporate shareholders will have to report dividend income pro tanto rather than apply the entire distribution in reduction of the basis of their stock.

It should not be forgotten that income realized in form by the distributees of "inventory assets" may be imputed to the corporation, e.g., if they promptly sell the assets in accordance with a prearranged plan or with the aid of corporate facilities. The relationship of the earnings and profits adjustments required by § 312(b) at the time of the distribution to the earnings and profits that are created by a later sale or other disposition imputed to the corporation is not illuminated by either the Code or the Regulations. It is surprising that the problem was left in such obscurity, since sales by the shareholders of inventory property or collections by them of "unrealized receivables or fees" would often—perhaps ordinarily—be imputed to the corporation.

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117 Supra, pp. 67.
118 At one time the Treasury adopted the view that earnings and profits were created by a distribution of appreciated property of any type. See Mintz and Plumb, supra, at 54-56.
119 In the case of LIFO inventory, both § 311(b), supra, p. 67, and § 312(b) may be applicable, so that the distribution will produce (a) taxable income (and hence earnings and profits) on the excess of FIFO value over LIFO value and (b) earnings and profits (but not taxable income) on the excess of fair market value over FIFO value. See § 312(c)(3); for an illustration, see Regs. § 1.312-4, Example (3).
120 The adjustments of § 312(b) must be made whether the distributees are corporations or individuals, but corporate distributees are denied a stepped-up basis by virtue of § 301(d)(2), supra, p. 75.
120a Supra, p. 69.
on the principles discussed supra, p. 68. Certainly the appreciation in value of such assets should not be reflected in earnings and profits more than once. Since § 312(b) requires an adjustment to earnings and profits at the time of the distribution, any later realization of taxable income should affect earnings and profits only to the extent that the appreciation has not already been taken into account.

3. Other adjustments. In addition to the foregoing adjustments, earnings and profits must be adjusted under §§ 312(c)(1) and (2) if in connection with the distribution, the shareholders assume, or take property subject to, any liability; or if any gain is recognized to the corporation under § 311(b) (relating to LIFO inventory) or § 311(c) (relating to liabilities in excess of basis).121

Earnings and profits ought also to be adjusted in the case of gain recognized on the distribution of installment obligations under § 311(a) and § 453(d). If such obligations constitute "inventory assets" as that term is defined by § 312(b)(2)(A), as would ordinarily be the case, the required adjustment would be made under § 312(b)(1).

C. Distribution of Corporation's Own Obligations

Distribution of corporation's own obligations. In lieu of distributing cash or property, the corporation may make a distribution to its shareholders of its own obligations, ordinarily (but not necessarily) evidenced by notes, bonds, debentures, or other securities. The Internal Revenue Code appears to assume that such a distribution will have the same tax consequences as a distribution of other types of property, but the Regulations depart from this assumption at certain points in the interest of simplicity.

In the case of a noncorporate distributee, it is reasonably clear (even though the Code is not explicit)122 that the distribution of a corporation's own obligations is a distribution of "property" under § 301(b)(1)(A), so that the "amount" of the distribution is the fair market value of the obligations. It follows that under §§ 301(c)(1) and 316 the distribution is a "dividend" to the extent of current and post-1913 earnings and profits, and that any excess is to be treated as a return of capital under §§ 301(c)(2) and (3). And, under

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121 Supra, p. 67.
122 Both § 301(b), regarding the "amount" of a distribution, and § 301(d), prescribing the basis of distributed property, speak of "property," without explicitly mentioning the distributing corporation's own obligations. Section 317(a), defining "property," is equally laconic, and the Regulations under § 317(a) state that the term "property" includes "indebtedness to the corporation," but say nothing about indebtedness of the corporation. Despite these unsatisfactory gaps, a distribution of the corporation's own obligations almost certainly is to be treated as a distribution of "property," and the regulations under § 301 so assume. See also § 312(a), which explicitly includes the corporation's own obligations within the term "property."
§ 301(d)(1), the basis of the distributed obligations in the hands of the distributee is their fair market value. In these respects, there is no difference between a distribution of the corporation's own obligations and a distribution of other types of property. It will be recalled, however, that if the distributee is a corporation, the "amount" of a distribution of property is the property's fair market value or its adjusted basis in the hands of the distributing corporation, whichever is the lesser. Although the Code itself does not state that a distribution of the corporation's own obligations is to be treated differently, the Regulations provide that the fair market value of the obligations is controlling, thus confining the operation of § 301(b)(1)(B) to distributions of property other than the corporation's own obligations. In most instances, of course, the letter of § 301(b)(1)(B) could not be applied to the corporation's own obligations, because they would have no adjusted basis; but it is possible for a corporation to issue securities and reacquire them, and in this event, they might be regarded as having an adjusted basis that could be controlling under § 301(b)(1)(B) if they were later distributed to shareholders. Despite this possibility, the Regulations under § 301(b) ignore the adjusted basis of the obligations. Similarly, § 301(d)(2) provides that the basis to a corporate distributee of "property" is its fair market value or its adjusted basis in the hands of the distributing corporation, whichever is the lesser, but the Regulations confine this provision to distributions of property other than the corporation's own obligations, and provide that the basis of such obligations is their fair market value.

Although the fair market value of the corporation's obligations controls both the "amount" of the distribution and the basis of the obligations, as just indicated, § 312(a)(2) provides that the distributing corporation's earnings and profits are to be reduced by the principal amount of the obligations. In many cases, these amounts will be identical. If the obligations are worth less than their face amount, however, the discrepancy between the distribution's impact on the shareholders and its effect on the distributing corporation's earnings and profits recognizes that the corporation's assets will eventually be reduced by the principal amount of the obligations, at least in the normal case where they are paid in full, and that the shareholders

123 Supra, p. 54.
124 Supra, p. 74.
125 See Regs. § 1.301-1(d).
126 The Regulations do not explicitly negate the significance of the adjusted basis of the corporation's own obligations in laying down the tax consequences of a bargain sale of "property" to a corporate distributee, Regs. § 1.301-1(j), but the omission is probably a mere oversight.
127 Regs. § 1.301-1(b)(2)(i).
(if they still hold the obligations at maturity) will recognize income
equal to the difference between the fair market value of the obligations
at distribution, which is their adjusted basis under § 301(d), and their
principal amount.\footnote{128 The shareholder would realize capital gain under § 1232(a)(1) if the obligation
was evidenced by a security, unless its fair market value at the time of distribution was
regarded as the “issue price” so as to bring into play the requirement of § 1232(a)(2)
that “original issue discount” be taxed as ordinary income.}
Perhaps it would have been theoretically more
accurate to charge earnings and profits at distribution with the fair
market value of the obligations, treating the difference between the
fair market value and the face amount as debt discount, and reducing
earnings and profits in an appropriate amount each subsequent year;
but the added complication would hardly have been worth the candle.

D. Distributions of Stock and Stock Rights

Introductory. The provisions of the 1954 Code relating to stock
dividends\footnote{129 This portion of the text is concerned with distributions by a corporation of its
own shares, or of rights to acquire its own shares. The distribution of shares of another
corporation is treated as a distribution in kind, governed by the principles discussed
infra, p. 64.} are the outgrowth of a long history of confusion and con­
flict that cannot be ignored in the interpretation of the new statute.
The Revenue Act of 1913 said nothing about stock dividends, and an
attempt by the Treasury to tax such dividends under the catch-all
language of what is now § 61(a), 1954 Code, was rejected by the
Supreme Court in \textit{Towne v. Eisner};\footnote{130 245 U.S. 418 (1918).} on the ground that a stock divi­
dend did not constitute “income” as that term was used in the statute.
The Revenue Act of 1916, however, explicitly provided that a “stock
dividend shall be considered income, to the amount of its cash value.”
But in \textit{Eisner v. Macomber},\footnote{131 252 U.S. 189 (1920).} the most celebrated case in the annals
of federal income taxation, the Supreme Court held that a distribution
of common stock by a corporation having only common stock out­
standing could not be constitutionally taxed as income to the share­
holders:

We are clear that not only does a stock dividend really take nothing
from the property of the corporation and add nothing to that of the
shareholder, but that the antecedent accumulation of profits evidenced
thereby, while indicating that the shareholder is the richer because of
an increase of his capital, at the same time shows he has not realized or
received any income in the transaction.

It is said that a stockholder may sell the new shares acquired in
the stock dividend; and so he may, if he can find a buyer. It is equally
true that if he does sell, and in doing so realizes a profit, such profit,
like any other is income, and so far as it may have arisen since the 16th
Amendment is taxable by Congress without apportionment. The same
would be true were he to sell some of his original shares at a profit. But if a shareholder sells dividend stock, he necessarily disposes of a part of his capital interest, just as if he should sell a part of his old stock, either before or after the dividend. What he retains no longer entitles him to the same proportion of future dividends as before the sale. His part in the control of the company, likewise is diminished. Thus, if one holding $60,000 out of a total of $100,000 of the capital stock of a corporation should receive, in common with other stockholders, a 50 per cent stock dividend, and should sell his part, he thereby would be reduced from a majority to a minority stockholder, having six fifteenths instead of six tenths of the total stock outstanding. A corresponding and proportionate decrease in capital interest and in voting power would befall a minority holder should he sell dividend stock; it being in the nature of things impossible for one to dispose of any part of such an issue without a proportionate disturbance of the distribution of the entire capital stock, and a like diminution of the seller's comparative voting power—that "right preservative of rights" in the control of a corporation. Yet, without selling, the shareholder, unless possessed of other resources, has not the wherewithal to pay an income tax upon the dividend stock. Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax. . . .

Mr. Justice Holmes, with whom Mr. Justice Day concurred, dissented, saying:

I think that the word "incomes" in the Sixteenth Amendment should be read in "a sense most obvious to the common understanding at the time of its adoption." . . . The known purpose of this Amendment was to get rid of nice questions as to what might be direct taxes, and I cannot doubt that most people not lawyers would suppose when they voted for it that they put a question like the present to rest. I am of opinion that the Amendment justifies the tax. 133

Mr. Justice Brandeis, with whom Mr. Justice Clarke concurred, dissented in a more elaborate opinion. The opinions in Eisner v. Macomber have been acutely and amply criticized, and there is no need to paraphrase here the views of the commentators. 134

Although the constitutional theory of Eisner v. Macomber has few defenders today, its practical importance to corporate practice and the collection of revenue has been overemphasized. Had the case gone the other way, stock splits would probably have been employed

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133 252 U.S. at 219-20.
as a substitute for stock dividends, coupled if necessary with periodic increases in par value or in stated capital; and if a method of taxing stock splits had been developed, fractional shares could have been used to serve the function of stock dividends without adverse tax consequences.

In response to *Eisner v. Macomber*, Congress provided in the Revenue Act of 1921\(^{135}\) that "a stock dividend shall not be subject to tax." Immunity was thus granted by statute to all stock dividends, whether the dividend shares were common or preferred and without regard to the number of classes of stock outstanding, although in *Eisner v. Macomber* the Supreme Court had passed only on a dividend of common on common by a corporation having no other class outstanding. The 1921 statute was silent on the question of basis, but the Treasury's regulations required the adjusted basis of the old stock to be allocated between the old shares and the dividend shares in proportion to their respective market values at the time of distribution.

The Treasury's provision for an allocation of the basis of the old shares was successfully challenged by a taxpayer in *Koshland v. Helvering*\(^{136}\) concerning a corporation having both common and non-voting preferred stock outstanding, which distributed common stock as a dividend on its preferred but not on its common. A preferred shareholder asserted that she was entitled to compute the gain on a sale of her original shares by using her full adjusted basis, without allocating any of that basis to the common stock received as a dividend. The Supreme Court held that when a stock dividend, unlike the one in *Eisner v. Macomber*, "gives the stockholder an interest different from that which his former stockholdings represented he receives income." The Court then held that the failure of Congress to tax the dividend shares on distribution did not authorize the Treasury to allocate part of the basis of the old shares to the dividend shares, thus agreeing with the taxpayer that the old shares retained their full basis for computing gain or loss on their disposition.\(^{137}\)

\(^{135}\) 42 Stat. 228.

\(^{136}\) 298 U.S. 441 (1936).

\(^{137}\) Besides making clear that *Eisner v. Macomber* did not immunize all stock dividends from tax, the *Koshland* case opened up the possibility of an escape from taxation by taxpayers who had accepted the benefit of the basis regulation by allocating part of their original basis to the dividend shares on selling such shares; it was possible that they could now claim the full original basis on selling the original shares. Not long after deciding the *Koshland* case, the Supreme Court held in *Helvering v. Gowran*, 302 U.S. 238 (1937), that under the 1921-36 revenue acts the basis of dividend shares was zero, since they had cost the shareholders nothing and were not taxed as income on receipt. This determination opened up the possibility—the converse of the possible escape from taxation under the *Koshland* case—that a taxpayer who had complied with the invalidated regulation on selling his original shares (by allocating part of his basis to the retained dividend shares) would have to use a zero basis on selling the dividend shares, and thus would not recoup his original investment tax-free. (Section 1311, which
In response to the *Koshland* case, Congress provided in § 115(f)(1) of the Revenue Act of 1936 that:

A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the stockholder within the meaning of the Sixteenth Amendment to the Constitution.

Did this section tender the Supreme Court an opportunity to re-examine *Eisner v. Macomber* or did it take that case as its starting point? In *Helvering v. Griffiths*, a majority of the Court held that Congress did not intend to invite a reconsideration of *Eisner v. Macomber*; the minority saw such an invitation, however, and expressed the view that *Eisner v. Macomber* should be overruled. As § 115(f)(1) of the 1939 Code was interpreted by the majority, then, "the tax status of a [pre-1954] stock dividend ... turns in effect on what would have been unconstitutional under *Eisner v. Macomber* if *Eisner v. Macomber* had been correct in its premise that a constitutional issue is present."

Just what stock dividends could be taxed under § 115(f)(1) of the 1939 Code, as thus construed, was veiled in obscurity. In *Strassburger v. Commissioner*, the Supreme Court held (by a 5-3 vote), that a distribution of a newly created issue of non-voting cumulative preferred stock by a corporation that had only common stock outstanding was not taxable. All of the common stock was owned by the taxpayer. The Court said:

While the petitioner ... received a dividend in preferred stock, the distribution brought about no change whatever in his interest in the corporation. Both before and after the event he owned exactly the same interest in the net value of the corporation as before. At both times he owned it all and retained all the incidents of ownership he had enjoyed before.

In *Helvering v. Sprouse*, decided at the same time as the *Strassburger* case, the Court held that a distribution of non-voting common stock by a corporation having both voting and non-voting common

now opens up the earlier year, despite the running of the statute of limitations, in certain cases where either the taxpayer or the government adopts inconsistent positions, was not enacted until 1938.) But in 1939, Congress enacted § 113(a)(19) of the 1939 Code, the predecessor of § 307(a) of the 1954 Code, adopting the allocation rules applied under the invalidated Treasury regulations, and also providing for situations in which income on the sale of either the original or dividend shares had been computed in a fashion inconsistent with the old regulations. Alvord and Biegel, Basis Provisions for Stock Dividends under the 1939 Revenue Act, 49 Yale L.J. 841 (1940).


140 318 U.S. 604 (1943).

141 318 U.S. at 607.
outstanding was also non-taxable. The non-voting common was distributed to the holders of both the voting and the non-voting common, but the taxpayer, before the stock dividend, owned only voting common stock. The government argued that the distribution came within the rule of the *Koshland* case that "where a stock dividend gives the stockholders an interest different from that which his former stock holdings represented he receives income." But the Court (5-3) held:

We think *Koshland v. Helvering* . . . distinguishable. That was a case where there were both preferred and common stockholders and where a dividend in common was paid on the preferred. We held, in the circumstances there disclosed, that the dividend was income but we did not hold that any change whatsoever in the character of the shares issued as dividends resulted in the receipt of income. On the contrary the decision was that, to render the dividend taxable as income, there must be a change brought about by the issue of shares as a dividend whereby the proportional interest of the stockholder after the distribution was essentially different from his former interest.142

With the *Strassburger* and *Sprouse* cases as their guides, the lower courts struggled with but did not solve the problem of separating taxable stock dividends from non-taxable ones.143 These decisions left so much uncertainty in the taxation of stock dividends under the 1939 Code that the draftsmen of the 1954 Code essayed a new approach to the problem. The cases just cited are of continuing importance, however, because pre-1954 law governs the basis of the original and dividend shares (and the earnings and profits of the distributing corporation) if a stock dividend was distributed before June 22, 1954.144

*Non-taxable stock dividends.* Section 305(a) lays down the general rule that "gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock." Concerned as it is with distributions by a corporation "with respect to [its] stock," § 305 has no effect on transfers of stock to creditors, vendors, employees, etc., who happen to be shareholders as well.145 Moreover, § 305 is limited to distributions of the corporation's own stock; distributions by a corporation of the stock of another corporation are treated as distributions of money or other

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142 318 U.S. at 607-8.
143 See, e.g., Tourtelot v. Commissioner, 189 F.2d 167 (7th Cir. 1951), cert. denied, 343 U.S. 901; Wiegand v. Commissioner, 194 F.2d 479 (3d Cir. 1952); Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954); Messer v. Commissioner, 20 T.C. 264 (1953).
144 See §§ 307(c), 312(d)(2), 391, and 1052(c).
145 See § 305(c)(3); and note the interpretations of virtually identical language in § 301(a) and § 313(a), found in Regs. § 1.301-1(c) and § 1.311-1(c), supra, p. 49. In Daggett v. Commissioner, 23 T.C. 31 (1954) (Acq.), however, a distribution of stock to shareholder-employees in payment of salary was held to be controlled by *Eisner v. Macomber*; Note, Application of *Eisner v. Macomber* to Pro Rata Stock Distributions in Payment of Salaries: An Opportunity for Tax Manipulation, 64 Yale L.J. 929 (1955).
property, to which § 305 has no application. Finally, § 305 is concerned with distributions of “stock” or of rights to acquire “stock.” Debt instruments are not subject to § 305. The Regulations, however, provide that § 305 applies to treasury stock and to rights to acquire treasury stock, as well as to unissued stock.

Although a stock dividend may be received tax-free under § 305(a), a sale, redemption, or other disposition of the stock may be subject to punitive treatment if it constitutes “section 306 stock.” The special rules of § 306 apply primarily to preferred stock distributed tax-free under § 305(a) by a corporation having earnings and profits at the time of the distribution.\textsuperscript{146}

Upon receiving a distribution of stock that is exempt from tax under § 305(a), the shareholder is required by § 307(a) to allocate the basis of the old stock between the old and the new stock under regulations to be prescribed. Pursuant to § 307(a), the Treasury requires an allocation of basis in proportion to the fair market values of the old and new stock on the date of distribution.\textsuperscript{147} The holding period of the new stock, for determining whether capital gain or loss on a sale or exchange is long-term or short-term, includes the period for which the shareholders held the old stock, by virtue of § 1223(5). The distributing corporation does not reduce its earnings and profits when it makes a non-taxable distribution of its stock,\textsuperscript{148} and the recipient, if a corporation, does not increase its earnings and profits on receiving such a distribution.\textsuperscript{149}

The statutory exceptions to the general rule of § 305(a) are discussed in the next section.

**Taxable stock dividends.** There are two exceptions to the general rule of § 305(a) that stock dividends are receivable tax-free:

1. **Optional distributions.** § 305(b)(2) provides that § 305(a) is inapplicable if the distribution is payable, at the election of any of the shareholders, either in stock or in property. The Senate Report on the 1954 Code states that this provision “continues the rule of the House bill and of existing law that where a shareholder has an election to take a dividend in stock or in cash, the election to take a stock dividend will not prevent the stock being subject to tax.”\textsuperscript{150} The corresponding provision of the 1939 Code, however, provided explicitly that if any of the shareholders had such an option, “the distribution shall constitute a taxable dividend in the hands of all shareholders,

\textsuperscript{146}For an examination of § 306, see Alexander and Landis, Bail-Outs and the Internal Revenue Code of 1954, 65 Yale L.J. 909 (1956).
\textsuperscript{147}Regs. § 1.307-1.
\textsuperscript{148}§ 312(d)(1)(B).
\textsuperscript{149}§ 312(f)(2).
\textsuperscript{150}S. Rept. No. 1622, 83d Cong., 2d sess., p. 44, 241.
regardless of the medium in which paid.\textsuperscript{151} Despite the reference in the Senate Report to “existing law,” the language of the 1954 Code does not state as clearly as did the 1939 Code that if any shareholder has an option to take cash or other property, all shareholders realize income. The Regulations, however, state that an option in one shareholder is fatal to all.\textsuperscript{152} If \textit{Eisner v. Macomber} is still valid, however, it could be argued that the Constitution does not permit a shareholder receiving a stock dividend that would be exempt under that decision to be taxed simply because some other shareholder has an option to take cash or other property.\textsuperscript{153}

If the shareholders have an election to take money or other property in lieu of stock, § 305(b)(2) is applicable whether the option is exercised before or after the distribution is declared. Plainly, § 305(b)(2) would become a dead letter unless it embraced options granted to the shareholder and exercised before the declaration, as well as those that arise and are exercised after the declaration. But how far back of the declaration was § 305(b)(2) intended to reach? A proposed amendment to the Regulations, pending at this writing (January, 1959), provides that if a corporation has two classes of common stock outstanding, one class being entitled to dividends in stock only while the other is entitled to dividends in cash, the shareholder who owns shares of the former class has an option, within the meaning of § 305(b)(2), since in the alternative he could have purchased the latter class of stock.\textsuperscript{154} If the shareholder could freely convert one class into the other, much could be said for the theory of the proposed regulation, but as applied to non-convertible shares, it is rather drastic. Even if the two classes of stock are identical except for their dividend rights, and are equal in value, the shareholder owning shares entitled to stock dividends only does not have an option to take cash currently, except by selling the stock he now holds and buying the other class; and neither this power nor his original decision to buy one class rather than the other seems to be the type of “election” to which § 305(b)(2) was intended to refer.\textsuperscript{155}

2. \textit{Preferred arrears}. The second exception to the nontaxability of stock dividends is § 305(b)(1), providing that a distribution "in discharge of preference dividends" for the corporation's current or

\footnotesize{\textsuperscript{151} § 115(f)(2), 1939 Code. \\
\textsuperscript{152} Regs. § 1.305-2(a). \\
\textsuperscript{153} See Bittker, Stock Dividends, Distributions in Kind, Redemptions, and Liquidations under the 1954 Code, 1955 So. Calif. Tax Inst. 349, 351. See also Lester Lumber Co. v. Commissioner, 14 T.C. 255, 261 (1950), stating that corporate law requires all stockholders to be treated alike, so that the corporation may not offer cash to a limited group of stockholders and require the others to accept a stock dividend. \\
\textsuperscript{154} 21 Fed. Reg. 5104. \\
\textsuperscript{155} See IRS Attempts To Stop 2-Classes-of-Common Tax-Saving Plan; Legality Questioned, 5 J. of Tax. 178 (1956).}
preceeding taxable year shall be treated as a § 301 distribution. The House version of the 1954 Code contained a similar exception, but it applied more broadly to any distribution in discharge of preference dividends, whether currently owing or in arrears. The provision as enacted "limits the taxability to stock dividends distributed in lieu of dividends on preferred stock which are in effect currently owing." If a distribution of stock is made to clear up arrears in preference dividends for a number of years, the portion attributable to the earlier years would be exempt from tax under § 305(a); only the portion of the distribution that is allocable to the arrears for the current and preceding taxable years would be taxed under § 305(b)(1). Even this mild measure can be avoided, in appropriate circumstances, if the arrears are cleared up by a recapitalization of the corporation.

A constitutional issue raised by § 305(b)(1) is not mentioned by the Senate Report on the 1954 Code. If a corporation with common and preferred stock outstanding, all in the hands of a single individual, distributes additional stock to discharge preference dividends, can the shareholder be taxed under the rule of Eisner v. Macomber? The Strassburger case suggests, though it did not explicitly hold, that a distribution of stock to the sole shareholder of a corporation can never be a taxable dividend. If this is true, it may be that § 305(b)(1) cannot be constitutionally applied if all the stock is owned by one shareholder or, possibly, if all classes are owned in the same proportions by a number of shareholders.

The Code does not define "preference dividends" as that term is used in § 305(b)(1). The Senate Report on the 1954 Code refers to "dividends on preferred stock." Does this include so-called "Class A" common stock, i.e., nonvoting stock with a dividend claim of a fixed amount which must be paid ahead of any dividends on Class B common and a right to participate in further dividends after a secondary "preference" of the Class B common stock has been satisfied? Under § 312(b) of H.R. 8300, the House version of the 1954 Code, apparently both Class A and Class B would be "nonparticipating stock," so that a stock distribution in discharge of their preference arrears would be taxable. The definition of "nonparticipating stock" was dropped by the Senate, but the main thrust of its amendments in this area was to tax only the discharge of preference dividends for the corporation's current and preceding taxable years, whereas the House version of the bill had taxed the discharge of all arrears. It is possible that no other changes were intended by the Senate, and the reference to "preference dividends" in § 305(b)(1) can certainly be
applied to both Class A and Class B stock, to the extent of their primary and secondary preferences. The Senate Report's reference to "dividends on preferred stock," on the other hand, appears to exclude the Class B stock and to leave ambiguous the status of Class A.

When stock dividends are subject to either § 305(b)(1) or § 305(b)(2), the distribution is to be treated as "a distribution of property to which section 301 applies." Under § 301(b), the "amount" of the distribution is its fair market value if the distributee is an individual; and the Regulations apply the same principle to corporate distributees, despite the fact that § 301(b)(1)(B) provides that corporate distributees shall use either the value of the distributed property or its adjusted basis in the hands of the distributing corporation, whichever is lower.159 Once the "amount" of the distribution is determined, it is taxable under § 301(c)(1) as a "dividend" to the extent of earnings and profits; the balance, if any, is a return of capital subject to §§ 301(c)(2) and (3).160 The basis of the distributed stock to a noncorporate distributee is fair market value under § 301(d)(1), and the same should be true of a corporate distributee, despite § 301(d)(2).161 The holding period of stock received in a taxable distribution commences with the distribution; there is no provision in § 1223 for "tacking" on the holding period of the old stock.

Stock Rights. Section 305 lumps together distributions of stock rights and distributions of the stock itself, providing that a distribution by a corporation of "rights to acquire its stock" is not includible in the shareholder's gross income, unless (a) the distribution is made in discharge of preference dividends for the corporation's current or preceding taxable year, or (b) the distribution is, at the election of any of the shareholders, payable either in stock rights or in property. Even though § 305 does not discriminate between stock and stock rights, however, a distribution of rights presents certain peculiar problems.162

In the case of a nontaxable distribution of rights, basis is to be allocated under § 307. The "general rule" prescribed by § 307(a) and

159 Regs. § 1.301-1(d). Ordinarily the distributing corporation would not have a basis for its own stock, but it might distribute treasury stock. A similar use of fair market value in measuring the "amount" of a distribution to a corporate distributee, to the exclusion of the distributing corporation's adjusted basis, was noted supra, p. —. Both § 317(b) and § 1032 can be cited in support of the Treasury's decision to disregard basis in the case of a distribution of stock; see Bittker, Stock Dividends, Distributions in Kind, Redemptions and Liquidations Under the 1954 Code, 1955 So. Calif. Tax. Inst. 349, 354.
160 Supra, p. 54.
161 See supra, note 159.
the Regulations issued thereunder is an allocation of basis between the old stock and the stock rights in proportion to their fair market values as of the date of distribution.\textsuperscript{163} The Regulations also state that basis is to be allocated only if the rights are exercised (in which case the amount allocated to the rights is added to the cost of the stock acquired by exercising the rights) or sold (in which case the amount allocated to the rights is used in determining the shareholder’s gain or loss on the sale).\textsuperscript{164} The effect of this limitation is that the shareholder realizes no loss if he allows the rights to expire without exercise or sale.

The rule of allocation is subject to an exception. Section 307(b) provides that if the fair market value of the rights is less than 15 percent of the fair market value of the old stock at the time of distribution, the basis of the rights shall be zero unless the shareholder elects to allocate basis under the method of allocation provided by § 307(a).\textsuperscript{165} The purpose of § 307(b) is to avoid the necessity for trifling basis adjustments on a distribution of rights of little value; unless the shareholder elects to allocate his basis, he uses a zero basis for the rights whether they are exercised (in which case the basis of the new stock is its actual cost) or sold (in which case the entire proceeds of sale will be taxable gain), leaving the basis of the old stock intact.

If the shareholder sells his rights, § 1223(5) permits the holding period of the underlying shares to be “tacked” on in determining the holding period of the rights if their basis “is determined under section 307”; this embraces rights with a zero basis under § 307(b), as well as rights with an allocated basis under § 307(a).\textsuperscript{166}

When a distribution of rights is taxable because the shareholders have an option to take property instead of rights or because the distribution discharges arrears in preference dividends for the corporation’s current or preceding taxable year, § 305(b) provides that “the distribution shall be treated as a distribution of property to which section 301 applies.” Under the 1939 Code, the rules relating to receipt, exercise, sale, and lapse of taxable rights were in a state of great confusion; and it is not entirely clear whether we are free of this legacy. The confusion resulted from \textit{Choate v. Commissioner},\textsuperscript{167} which in turn rested upon \textit{Palmer v. Commissioner},\textsuperscript{168} holding (a) that a distribution of rights was not taxable, even though a distribution of the stock subject to the rights would have been taxable, in the

\textsuperscript{163} Regs. § 1.307-1(b).
\textsuperscript{164} Regs. § 1.307-1.
\textsuperscript{165} The method of making an election is set out in Regs. § 1.307-2.
\textsuperscript{166} Rev. Rul. 56-572, 1956-2 C.B. 182.
\textsuperscript{167} 129 F.2d 684 (2d Cir. 1942).
\textsuperscript{168} 302 U.S. 63 (1937).
absence of a corporate intention to distribute earnings (ordinarily evidenced by the existence of a substantial "spread" between option price and fair market value of the stock at the time of distribution); and (b) that even when such a corporate intent was manifest, income was realized only upon exercise or sale of the rights, not upon issuance.\textsuperscript{169}

The pre-1954 rules for taxable rights rested on a reading of the 1939 Code, however, and it may be that they have been swept away by the 1954 Code. Under § 305(b), stock rights are taxable only if issued in discharge of preference dividends for the corporation's current or preceding taxable year or if the shareholders can elect to receive property instead of the rights; and it would not be unreasonable to take the new statute at face value in these narrow circumstances: 

\textit{viz.}, that the distribution "shall be treated as a distribution of property to which section 301 applies," with the result that the distribution itself would be taxable (assuming adequate earnings and profits) to the extent of the fair market value of the rights, whether they are subsequently sold, exercised, or allowed to lapse. On this theory, a lapse of the rights would give rise to a deductible loss.

\textsuperscript{169} See also Gibson v. Commissioner, 133 F.2d 308 (2d Cir. 1943); Tobacco Products Export Corp. v. Commissioner, 21 T.C. 625 (1954) (N. Acq.); G.C.M. 25063, 1947-1 C.B. 45; Whiteside, supra, note 162 at 1018-22.
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