Recent Developments Under Section 304 of the Internal Revenue Code

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Repository Citation
Yerachmiel E. Weinstein, Recent Developments Under Section 304 of the Internal Revenue Code, 64 Marq. L. Rev. 311 (1980).
Available at: http://scholarship.law.marquette.edu/mulr/vol64/iss2/3

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I. INTRODUCTION

Section 304 of the Internal Revenue Code¹ is a tax plan-

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1. I.R.C. § 304, entitled "Redemption Through Use of Related Corporations," reads as follows:

(a) Treatment of Certain Stock Purchases. —

(1) Acquisition by related corporation (other than subsidiary). — For purposes of sections 302 and 303, if —

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation.

(2) Acquisition by subsidiary.—For purposes of sections 302 and 303, if —

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

(b) Special Rules for Application of Subsection (a). —

(1) Rule for determinations under section 302(b). — In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation. In applying section 318(a) (relating to constructive ownership of stock) with respect to section 302(b) for purposes of this paragraph, sections 318(a)(2)(C) and 318(a)(3)(C) shall be applied without regard to the 50 percent limitation contained therein.

(2) Amount constituting dividend. —

(A) Where subsection (a) (1) applies. — In the case of any acquisition of stock to which paragraph (1) (and not paragraph (2)) of subsection (a) of this section applies, the determination of the amount which is a dividend shall be made solely by reference to the earnings and profits of the acquiring corporation.

(B) Where subsection (a) (2) applies. — In the case of any acquisi-
This is true for at least three reasons: (1) the section is a very potent weapon in the hands of the Commissioner for recasting transactions falling within its express terms; (2) it is plagued with internal inconsistencies which shed doubt on the way a particular qualifying transaction will be characterized; and (3) it is capable of being construed to cover a host of other transactions not expressly falling within its terms.

First, this article will examine the structure and operation of section 304 in terms of the types of transactions it was intended to cover. This will include a historical analysis to illustrate the reasons for the section's enactment. Second, a discussion of the uncertainties and inconsistencies in the operation of section 304 will be presented, with a view toward determining what light, if any, has been shed on some of these problems by recent judicial and administrative developments. Finally, a number of areas of potential conflict between section 304 and other Code sections will be examined, along with many of the suggestions which have been made as to possible resolutions of these conflicts.

II. THE HISTORY AND STRUCTURE OF SECTION 304

A. Historical Background

Section 304 is primarily intended as a reinforcement to the corporate distribution and redemption provisions of sections 301 and 302. Before the enactment of section 304, these provisions were capable of being easily circumvented by the use of a related corporation. This can be illustrated by the pre-section 304 case of Rodman Wanamaker Trust v. Commissioner, in which the taxpayer, who owned virtually all the stock of the parent corporation, sold part of that stock to the parent corporation’s wholly-owned subsidiary. The economic effect of that transaction was identical to a redemption by the parent of its own stock, which would be essentially equivalent to a dividend under section 115(g) of the Internal Revenue Code of 1939. This is because the taxpayer, by reason of the sale to the subsidiary, did not lose any control over the economic unit; virtually the only stock of the parent not held by the taxpayer after the transaction was held by a wholly-owned subsidiary of the parent. The Commissioner argued that since the taxpayer’s control was undiluted by reason of the sale, the result was no different than if a partial redemption by the parent of its own stock had taken place. However, this argument was rejected by the court because section 115(g) required a redemption by a corporation of its own stock.

This line of reasoning left a rather large loophole in the redemption provisions of the Code. Congress eliminated the loophole by enacting section 115(g)(2) to cover the parent-subsidiary situation present in the Wanamaker case. The

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4. 11 T.C. 365 (1948), aff’d per curiam, 178 F.2d 10 (3rd Cir. 1949).


7. The Tax Court cited Mead Corp. v. Commissioner, 116 F.2d 187 (3d Cir. 1940), which held that the predecessor of the accumulated earnings tax provisions in the 1939 Code did not apply to accumulations by a subsidiary to avoid tax on the shareholders of the parent. See Kempf, supra note 3, at 62 n.4.

House proposed an amendment covering brother-sister corporations, that is, when the same shareholders control two corporations, while neither of the corporations controls the other. The Senate, however, rejected the House proposal, reasoning that the brother-sister situation was not as ripe for abuse. The House view of the matter proved to be unusually prescient, for the brother-sister situation was soon thereafter presented to the Tax Court in *Emma Cramer*.

The *Emma Cramer* case involved a family who, either directly or beneficially, held all the stock in four corporations and who proceeded to sell the stock of three of them to the fourth which then liquidated the other three. Because taxpayer succeeded in bailing-out the earnings and profits of three corporations, it is understandable that the Commissioner wished to have these earnings and profits taxed to the shareholder as dividends. The Tax Court, however, held against the Commissioner. It reasoned that section 115(g)(2) extended only to the parent-subsidiary situation, and that section 115(a) (the predecessor to present section 301) did not cover the situation, for to construe that section so broadly would be to render section 115(g) (the redemption section) meaningless. As such, the related corporation loophole still existed even after the enactment of section 115(g)(2).

### B. Present Section 304

When Congress revised the Internal Revenue Code in 1954, it responded to the problem of the related-corporation loophole by enacting section 304. Coverage was expanded beyond that of the predecessor, section 115(g)(2) of the 1939 Code, to include the brother-sister situation involved in the *Cramer* case. In addition, the reach of section 304 was extended further by incorporating with some modifications, the

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12. 20 T.C. 679 (1953).
13. Id. at 684. See Kempf, supra note 3, at 63.
new attribution rules of section 318. The major objective of Congress was to prevent tax avoidance through "sales of stock between corporations owned by the same interests."\textsuperscript{14}

On its face, the structure of section 304 is not particularly complex, considering the fact that its coverage was expanded to include both parent-subsidiary and brother-sister situations. Section 304(a)(1), the rule for the brother-sister situation, states that when the same interests control two corporations and the stock of one (issuing corporation) is sold to the other (acquiring corporation), the sale is treated as a redemption by the acquiring corporation. Since in reality none of the stock of the acquiring corporation was actually redeemed so that the number of shares outstanding was unchanged by the sale, the section creates the legal fiction of a contribution to the capital of the acquiring corporation in exchange for its stock, followed by a redemption of that stock.

Section 304(a)(2) covers the parent-subsidiary situation. It sets down the rule that where the shareholder of a parent corporation sells stock of the parent to its subsidiary, the sale will be treated as a redemption by the parent. Note that while control of two corporations by the same shareholders is required in the brother-sister situation, the only control required in the parent-subsidiary situation is control by the parent of the subsidiary; the shareholders need not control either corporation.

Section 304(b) deals with the treatment of the fictional redemption created by section 304(a). Paragraph (1) requires that the test for dividend equivalency under section 302(b) is, in all cases, to be made with reference to the stock of the issuing corporation. It also eliminates, for purposes of the section 302(b) test, the fifty percent limitation on the operation of corporate back attribution\textsuperscript{15} and beneficial-interest attribution.\textsuperscript{16} Paragraph (2) of section 304(b) addresses itself to the situation in which a redemption is characterized as the equivalent of a dividend, and section 301, by way of section 302(d), is applicable. Since section 301(c)(1) refers to section

\textsuperscript{15} I.R.C. § 318(a)(3)(C).
\textsuperscript{16} I.R.C. § 318(a)(2)(C).
316 to calculate the amount of the distribution constituting a dividend according to accumulated and current earnings and profits, the question arises as to which corporation's earnings and profits are examined. Paragraph (2)(A) of section 304(b) states that in the brother-sister situation the earnings and profits of the acquiring corporation are used to determine the amount of the dividend, while paragraph (2)(B) dictates that in the parent-subsidiary situation, combined earnings and profits of both the parent and the subsidiary are used. To accomplish this, a fictional distribution by the subsidiary to the parent is created, in the amount of the redemption, which is then used by the parent to redeem its own stock.

The last paragraph of section 304(c) contains a number of definitions. In paragraph (1), control is defined as the ownership of stock comprising either 50% of voting power or 50% of value. To avoid the dilution which results in situations of corporate beneficial-interest attribution by reason of the fact that the percentage of stock owned by the corporation which is attributed to the shareholder is limited to the shareholder's percentage ownership of the corporation, the section goes on to provide that wherever a shareholder owns a 50% or greater interest in a corporation which owns a 50% or greater interest in another corporation, for purposes of the section the shareholder will be deemed to control the other corporation. Paragraph (2) makes the attribution rules of section 318 applicable to the determination of control, eliminating as before the 50% limitation on corporate back attribution and beneficial-interest attribution.

With the application of the attribution rules, section 304 becomes a potent weapon indeed; it reaches situations in which neither corporation controls the other nor does the shareholder control either of them. For instance, if shareholder X owns 25% of corporation A and 25% of corporation B, and corporation A in turns owns another 25% in corporation B, X's 25% of corporation B will be attributed to corporation A by back attribution, giving corporation A 50% of

17. Id.
18. See I.R.C. § 304(b)(1) with respect to the elimination of the percentage limitations on corporate attribution in testing for dividend equivalency under I.R.C. § 302(b).
corporation B. Therefore, the parent-subsidiary situation is created. The reach of section 304 was somewhat narrowed when sidewise attribution was eliminated in 1964, but even so it remains, by its terms, far-reaching. To compound the aforementioned problems, there are a number of uncertainties and inconsistencies in the operation of the section.

III. UNCERTAINTIES AND INCONSISTENCIES IN THE OPERATION OF SECTION 304

A. Overlap

Section 304 deals with two situations: the parent-subsidiary situation and the brother-sister situation. The section in two instances gives preference to the parent-subsidiary characterization when a transaction fits the definition of both situations. It can also be demonstrated that whenever the brother-sister situation exists, the parent-subsidiary situation also exists by application of the attribution rules. The brother-sister situation requires that a shareholder, X, own at least 50% of two corporations, A and B. But, by application of corporate back attribution, X's 50% ownership of corporation B is attributed to corporation A and his 50% of corporation A is attributed to corporation B. The result is that corporation A is the parent of corporation B and B is the parent of A. The converse is not always true; the parent-subsidiary situation can exist without being recharacterized as a brother-sister situation. For example, if shareholder X owns 25% of corporations A and B and at the same time, corporation A owns 25% of corporation B, X's 25% of corporation B will be attributed to corporation A giving A control of B so that A is the parent of B. But, owing to the percentage limitation on corporate beneficial-interest attribution, there is no way to attribute control of both corporations to X. Thus, while the

parent-subsidiary situation does not necessarily imply the existence of the brother-sister situation, the brother-sister situation does necessarily imply the parent-subsidiary situation. If the parent-subsidiary situation is to take precedence whenever both exist, the brother-sister situation is effectively read out of the statute.

Many suggestions have been made for resolving this dilemma. For instance, it has been suggested that the brother-sister situation be applied wherever it exists, but it is not clear what this means. Where, for example, shareholder X owns 100% of corporation A which owns 100% of corporation B, the relationship is clearly one of parent-subsidiary, but it can also be characterized as brother-sister by attributing corporation A's 100% ownership of corporation B to X. To say that the brother-sister characterization takes precedence runs against the clear mandate of the statute. It has also been suggested that the parent-subsidiary characterization be applied only when an actual parent-subsidiary relationship exists. However, this would take the example given above of a shareholder owning 25% of two corporations along with one corporation owning 25% of the other out of the section altogether.

Fortunately, some light has recently been shed on this problem by the Seventh Circuit in *Broadview Lumber Co. v. United States.* In discussing whether the contribution to capital fiction which applies in the brother-sister situation will also apply in the parent-subsidiary situation, the court noted the overlap between the two and resolved the problem by holding that the brother-sister characterization will apply when, and only when, a brother-sister relationship exists without resort to corporate attribution. Although the court went

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24. See generally Brown, supra note 3, at 775-77; Marans, supra note 2, at 165-66.
25. Marans, supra note 2, at 165.
27. Marans, supra note 2, at 166.
28. See id.
29. 561 F.2d 698 (7th Cir. 1977).
31. 561 F.2d at 706.
32. [T]he contribution to capital treatment of the acquired stock must apply only to corporations which are actually related as brother-sister, even though
on to state that the parent-subsidiary rules apply only when such a relationship exists without corporate attribution, that statement can be seen as dictum given the issue before the court.

The court's decision established a two-tiered order of preference in characterizing the corporate relationship as either brother-sister or parent-subsidiary. The statutory preference for the latter characterization, of course, remains in place. In addition, there is a preference for characterizing the relationship without resort to the corporate attribution rules. Where the relationship can be characterized only as parent-subsidiary, of course, that characterization will apply. The court would have the parent-subsidiary preference control where either both characterizations can be made without application of the corporate attribution rules or where both can be made only with application of those rules. However, when one characterization can be made without application of the corporate attribution rules, while the other can be made only with such application, the preference for characterization without applying the attribution rules will control.

The principles of the preceding paragraph can be illustrated by way of the following examples: (1) X owns 25% of corporations A and B, with corporation A owning 25% of corporation B. Even with corporate attribution, the relationship by resorting to the attribution of ownership rules one could convert what would be a parent-subsidiary relationship into a brother-sister relationship simply because one person or persons was also in control of the parent corporation.

*Id.* at 709 (footnote omitted).

33. "Conversely, the redemption and distribution rules of section 304(a)(2) should only apply when the parent corporation had the necessary control of the subsidiary corporation without resort to constructively owned stock." *Id.* (footnote omitted).

34. The parent-subsidiary characterization issue arose in connection with the question of whether the acquiring corporation purchased the stock of the issuing corporation within the meaning of I.R.C. § 1033(a)(2)(A)(ii). Under that section, the gain on the involuntary conversion of property will qualify for nonrecognition only if the property or stock purchased to replace the destroyed property is purchased in a transaction in which the basis of purchased property or stock is equivalent to its cost. The acquiring corporation purchased the stock in the issuing corporation because it was engaged in a related business, having made the purchase with the insurance proceeds from the involuntary conversion of its assets and wished to qualify the purchase for nonrecognition of the involuntary conversion gain under I.R.C. § 1033(a)(2)(A)(ii). Thus, the question of the acquiring corporation's basis in the issuing corporation's stock was significant. 561 F.2d at 705.
can only be characterized as parent-subsidiary, so that characterization will be applied. (2) X owns 50% of corporation A and B and corporation A owns the other 50% of corporation B. Both characterizations can be made without applying the corporate attribution rules, so the parent-subsidiary characterization will take precedence. (3) X owns 100% of corporation A and 25% of corporation B, with A owning another 25% of B. Both characterizations can be made, but only by applying the corporate attribution rules, so the parent-subsidiary characterization will be applied. (4) X owns 100% of corporation A which, in turn, owns 100% of corporation B. The parent-subsidiary characterization can be made without the application of the corporate attribution rules, but the brothersister characterization can only be made with such application. The preference for characterization without attribution will control, so the relationship will be cast as parent-subsidiary. (5) X owns 50% of corporations A and B. The brothersister characterization exists without attribution while the parent-subsidiary characterization exists only with attribution. The preference for characterization without corporate attribution will control, and the relationship will be cast as brother-sister.

This rule is consistent with the examples given in the regulations. In the regulations, the brother-sister characterization is applied when it exists without corporate attribution even though the parent-subsidiary characterization would also exist with such attribution. It should be noted that it is only corporate attribution which is shunned where possible; family attribution, for instance, would not affect the choice between possible characterizations. A further question may be raised: If this is the rule, what is the purpose of the provision in the section which deems shareholder X, a 50% shareholder of corporation A, to have control of corporation B simply because corporation A has a 50% interest in B? The parent-subsidiary relationship would exist even without the provision and without the application of the corporate attribution rules; therefore, such relationship should take precedence and there

36. See id. Ex. (4) (involving family attribution).
37. I.R.C. § 304(c)(1) (last sentence).
is no need for the provision. The provision is also unnecessary if the real parent becomes the acquiring corporation because, even without such a provision the shareholder’s control of the acquiring corporation would be attributed to the issuing corporation and the parent-subsidiary relationship will exist by attribution. Since the brother-sister relationship also exists only by attribution, the former relationship should take precedence regardless of the provision.

But before relegating the provision to the realm of congressional oversight,\(^3\) consider the following situation: X owns 50% of corporation A which owns 50% of corporation B. X also owns 50% of corporation C. X sells C stock to B. Without the provision, X will own 25% of B by beneficial-interest attribution from corporation A, which will, in turn, be attributed to corporation C by back attribution. But C’s 25% interest in B is not enough for a parent-subsidiary relationship to exist, nor is X’s 25% interest in corporation B enough for a brother-sister relationship. With the provision, however, X is deemed to own a 50% interest in corporation B, enough for both a brother-sister and a parent-subsidiary relationship to exist. It may be that the relationship should still be cast as parent-subsidiary, as per the above discussion. In that case the effect of the provision would simply be to extend section 304 coverage where it would not otherwise exist.

B. Basis Rules

Section 304 is substantially silent on the determination of basis, either for the corporation or the shareholder.\(^3\) The regulations, however, do develop a method for the determination of basis, at least in the brother-sister area.\(^4\) Furthermore, *Broadview Lumber,*\(^4\) along with some of its

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38. Similar to I.R.C. § 356(a)(2), according to the argument advanced in Cohen, *Stock Redemptions Through the Use of Controlled Corporations: Why Haserot Was Wrong,* 28 Case W. Res. L. Rev. 289, 304 n.82 (1978) [hereinafter cited as Cohen] to the effect that § 304 should override the reorganization sections where both provisions could be applied, rendering the specific dividend treatment in the reorganization sections unnecessary. A contra argument is made at text accompanying notes 141 & 142 infra.

39. The only light shed by the section itself is its inclusion of the contribution to capital rule in I.R.C. § 304(a)(1) (last sentence).


41. 561 F.2d 698 (7th Cir. 1977).
predecessors,\textsuperscript{42} addressed the question of basis in the parent-subsidiary situation.

1. Brother-Sister Situation

To deal with the brother-sister area, it is necessary initially to distinguish two situations: (1) where the constructive redemption is treated as a dividend, and (2) where the constructive redemption meets the tests of section 302(b)\textsuperscript{43} for non-dividend equivalency. In the first situation, the contribution to capital rule\textsuperscript{44} will give the acquiring corporation a basis in the stock constructively redeemed equal to the shareholder's basis in the stock.\textsuperscript{45} The shareholder is allowed to step-up his basis in his remaining shares in the acquiring corporation by an amount equal to his basis in the shares constructively redeemed.\textsuperscript{46} In a situation in which the shareholder actually owns no shares of the acquiring corporation but is deemed to be in control thereof only by attribution, the disappearing basis rules,\textsuperscript{47} along with \textit{Coyle v. United States},\textsuperscript{48} might have been interpreted to allow the actual owner of the shares attributed to step-up his basis. However, the Service has issued a ruling stating it will not allow such a step-up in

\begin{footnotesize}
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\item[42.] Webb v. Commissioner, 67 T.C. 293 (1976), \textit{aff'd per curiam}, 572 F.2d 135 (5th Cir. 1978); Virginia Materials Corp. v. Commissioner, 67 T.C. 372 (1976) (not dealing directly with the basis question, but dealing with the constructive dividend issue). \textit{See Britker & Eustice, supra} note 21, at 9-51 n.130.
\item[43.] This article does not deal specifically with the application of the § 302(b)(1) essentially equivalent to a dividend test to the context of related-corporation redemptions. As long as a "business purpose" could lead to a finding of nonequivalency, see, \textit{e.g.}, Kerr v. Commissioner, 326 F.2d 225 (9th Cir.), \textit{cert. denied}, 377 U.S. 963 (1964), there was some question as to whether related-corporation redemptions could be distinguished from ordinary redemptions on the basis of the business purpose of integrating the related corporations. Marans, \textit{supra} note 2, at 208-15; \textit{see also} Kempf, \textit{supra} note 3, at 90-94. With the decision of the Supreme Court in United States v. Davis, 397 U.S. 301, \textit{reh. denied}, 397 U.S. 1071 (1970), however, the business purpose test was eliminated from consideration under § 302(b)(1), so there is no longer any reason for related-corporation redemption cases to be treated any differently. \textit{See Brown, supra} note 3, at 762-66.
\item[44.] I.R.C. § 304(a)(1) (last sentence).
\item[45.] I.R.C. § 362(a).
\item[47.] \textit{See} \textit{e.g.}, Treas. Reg. § 1.302-2(c), Ex.(2) (1955). \textit{See generally Tiger, Sales of Stock to Related Corporations: Current Problems under Section 304, 40 J. Tax 86, 88-89 (1974) [hereinafter cited as Tiger].}
\item[48.] 415 F.2d 488 (4th Cir. 1968).
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The ruling involved \( B \) corporation, 70% of which was owned by corporation \( A \) which also owned 100% of corporation \( C \). \( B \) sold all of the stock of its wholly-owned subsidiary to corporation \( C \). The Service characterized the relationship as brother-sister,\(^{50}\) attributing the interest in corporation \( C \) held by \( A \) to \( B \) by back attribution. But \( B \) owned no actual shares of \( C \) and \( A \) was not allowed to step-up its basis in its shares of \( C \) company.

The ruling has been criticized by one commentator as a departure from Coyle.\(^{51}\) One explanation given\(^{52}\) by commentators is that the Service was reluctant to give the actual owner a step-up in basis because the constructive owner, a corporation, was eligible for the 85% dividends-received deduction.\(^{53}\) That reasoning would seem to indicate that the ruling is limited to the inter-corporate situation, so that if an individual owns shares in the acquiring corporation only by attribution, the disappearing basis result will not follow. Indeed, the Service has subsequently ruled\(^{54}\) that an individual owning shares in the acquiring corporation only by attribution, who retains some shares in the issuing corporation, will get a stepped-up basis in the latter shares.\(^{55}\) This follows the spirit, but not the letter of Coyle, in which the actual owner got the stepped-up basis.

Of course, the basis determination for the shareholder is also significant in the situation in which the acquiring corporation's earnings and profits are insufficient to cover the

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50. It could be so characterized only by application of the corporate attribution rules and, with their application, it could also be characterized as parent-subsidiary in the following way: \( A \)'s 100% of \( C \) is attributed to \( B \) by back attribution, and \( B \)'s 100% of \( C \) is attributed to its wholly-owned subsidiary by back attribution. The subsidiary, which is the issuing corporation, thereby becomes the parent of \( C \), the acquiring corporation.

Not only would such a characterization be in keeping with the preference which has been developed, see text accompanying notes 29-35, supra, but it would also eliminate the disappearing basis problem, since, in a parent-subsidiary situation, it is the shareholder's basis in his issuing corporation shares which is affected, and the selling shareholder always actually owns shares in the issuing corporation, or else he would have nothing to sell.

51. See Tiger, supra note 47, at 89.

52. Id. at 88.


55. See Tiger, supra note 47, at 89 n.19.
selling price of the issuing corporation's shares. Section 301(c)(2) mandates a reduction in basis in that situation, which in the brother-sister context would mean a reduction in the shareholder's basis of his shares in the acquiring corporation. If the shareholder owns such shares only by attribution, the preceding discussion will determine whether the basis of the actual owner is to be reduced, whether the basis of the shareholder in his remaining shares of the issuing corporation is to be reduced, or whether the entire excess over earnings and profits must be recognized as a gain.

The second situation in the brother-sister context is one in which the constructive redemption meets the test of section 302(b) for non-dividend equivalency. In this situation, the contribution to capital rule will dictate a basis in the shares acquired which is equal to their cost to the acquiring corporation. This results because the carryover basis from the selling shareholder will be increased by the amount of the gain recognized, which is equal to the difference between the selling price and the shareholder's basis. The shareholder will get no step-up in basis, since he is deemed to sell back the shares in the acquiring corporation fictionally received in exchange for the contribution to capital when he receives the selling price from the acquiring corporation.

There is some question as to whether the general rule of nonrecognition to the corporation (section 311(a)) or the rule of recognition for appreciated property (section 311(d)) applies in the section 304 situation, since each of the two rules is limited by its terms to stock of the redeeming corporation. The consensus seems to be that both rules apply to constructive redemptions. By a parity of reasoning, the rule con-

57. In accordance with the result in Coyle v. United States, 415 F.2d 488 (4th Cir. 1968).
60. I.R.C. § 304(a)(1) (last sentence).
61. See I.R.C. § 362(a) to the effect that the shareholder's gain recognized will be added to the corporation's basis. This fact is significant in light of the holding in Broadview Lumber Co. v. United States, 561 F.2d 698 (7th Cir. 1977) that, in the parent-subsidiary situation, the subsidiary gets a cost basis.
62. See Brown, supra note 3, at 773-74; Tiger, supra note 47, at 89-90.
63. The consensus is, more particularly, that either both apply or neither applies.
tained in section 312(a)(relating to reduction of the earnings and profits of the distributing corporation by the amount of the dividend) should also apply in the case of a brother-sister redemption which constitutes a dividend. Such reasoning is even clearer, since section 304 treats the distribution constituting a dividend as one made with respect to the stock of the acquiring corporation.

Under the foregoing analysis, the tax accounting effect on the acquiring corporation of a brother-sister redemption constituting a dividend would be as follows: (1) a debit to other assets and a credit to contributions to capital in the amount of the basis of the stock sold; (2) a debit to earnings and profits and a credit to cash (or other property account) in the amount of the selling price. However, when the constructive redemption is not treated as a dividend in the brother-sister situation, the tax accounting effect is as follows: (1) a debit to other assets and a credit to contributions to capital in the amount of the basis of the stock sold plus the gain recognized by the shareholder; (2) a debit to contributions to capital and a credit to cash (or other property account) in the amount of the selling price. In effect, then, the contribution to capital is removed from the books and the transaction is treated as a purchase of the stock with a basis equal to its cost.

2. Parent-Subsidiary Situation

With respect to the parent-subsidiary situation, the silence of the statute on the subject of basis determination is matched by silence in the regulations. The contribution to capital rule is not mentioned in the parent-subsidiary situation as it is in the brother-sister situation. However, with

See Brown, supra note 3, at 774 n.107; Tiger, supra note 47, at 90. But see Treas. Reg. § 1.311-2(a)(2) (1972) (§ 311(d) applies in § 304 situations).

64. See Brown, supra note 3, at 773-74; Marans, supra note 2, at 176.

65. Particularly in view of the fact that the amount of the dividend is determined by the earnings and profits of the acquiring corporation. I.R.C. § 304(b)(2)(A).

66. Marans, supra note 2, at 177.

67. See Marans, supra note 2, at 177-79 for a discussion of why the entire amount of the distribution is "properly chargeable to capital account" under I.R.C. § 312(a), so that no earnings and profits are carried out.

68. See Marans, supra note 2, at 179.

69. Treas. Reg. § 1.304-3(a) (1955) deals only with the situation of dividend equivalency.
respect to the question of whose earnings and profits account is charged if the constructive redemption is treated as a dividend, the statute does provide in the parent-subsidiary situation for a hypothetical distribution from the subsidiary to the parent followed by a distribution in redemption from the parent. This would seem to suggest some type of charge both to the subsidiary and to the parent.

The decision of the Seventh Circuit in Broadview Lumber, however, has implications both for the question of basis determination and for the question of charging earnings and profits. The court was faced, inter alia, with two issues: (1) In a parent-subsidiary constructive redemption, does the parent recognize a constructive dividend from the subsidiary? (2) Does the subsidiary get a cost basis in the parent’s stock? The case involved a sale by the parent’s sole shareholder of all the parent’s stock to the subsidiary. This resulted in a section 302(b)(3) complete termination of interest, so the constructive redemption was not treated as a dividend to the shareholder.

In dealing first with the constructive dividend issue, the court was faced with a ruling by the Service to the effect that such a dividend would be recognized by the parent. In very broad language, the court rejected that ruling; however, in a footnote, the court arguably limited its holding to the facts of the case in which the shareholder did not receive dividend treatment. On the second issue of a cost basis to the subsidiary, the court rejected the Commissioner’s argument that the contribution to capital rule should apply to the parent-subsidiary situation as well, but indicated, again in a footnote, that the argument against a cost basis depended on the contribution to capital rule only because the constructive dividend argument was rejected. This means that if the constructive dividend holding is limited to situations of non-dividend equivalency, the cost basis holding should be so limited as well.

To start with the known and then proceed to the un-
known, the Broadview Lumber\textsuperscript{76} case does determine the situation of non-dividend equivalency in the parent-subsidiary context. The subsidiary receives a cost basis in the parent’s stock. Since there is no contribution to the subsidiary’s capital by the shareholder and he is deemed, rather, to sell the stock, the shareholder must deduct the basis of the stock sold from his basis in his remaining stock of the parent.\textsuperscript{77} Since the subsidiary gets a cost basis in the stock, the entire amount is debited to the subsidiary’s assets and no charge need be made to earnings and profits (as would be the case if the subsidiary were redeeming its own stock).\textsuperscript{78}

So much for the known; now for the unknown. As indicated before, the Broadview Lumber\textsuperscript{79} case can be read broadly enough to always give the subsidiary a cost basis in the parent’s stock,\textsuperscript{80} even in the situation of dividend equivalency. But, it is submitted that this would lead to inconsistent tax accounting results. In the situation of dividend equivalency, there is necessarily a charge to the subsidiary’s earnings and profits in the amount of the distribution.\textsuperscript{81} There may also be a charge to the subsidiary’s assets since it now has stock in its parent which it did not previously have, with the amount of the charge equal to the subsidiary’s basis in the stock. In addition, there is a credit to cash (or other property account) in the amount of the distribution, which matches the charge to earnings and profits. Furthermore there must be a credit in the amount of the charge to assets for the stock in the parent, the amount of which will determine the basis of that stock. If the amount of that credit is equal to the cost of the stock, the question arises: What account is to be so credited? It cannot be a contribution to capital account, because a contribution to capital would have a carryover basis since no gain is recognized to the shareholder.\textsuperscript{82} If the amount to be credited were equal to the basis of the stock, the account to be credited would have to be a contribution to capital ac-

\textsuperscript{76} 561 F.2d 698 (7th Cir. 1977).
\textsuperscript{77} See Marans, supra note 2, at 172-73.
\textsuperscript{78} Under I.R.C. § 312(e). See Marans, supra note 2, at 173.
\textsuperscript{79} 561 F.2d 698 (7th Cir. 1977).
\textsuperscript{80} See Britker & Eustice, supra note 21, at 9-51 n.130.
\textsuperscript{81} I.R.C. § 312(a).
\textsuperscript{82} I.R.C. § 362(a).
count, since, in the case of a shareholder contribution to capital,\(^8\) the basis of the property contributed in the hands of the shareholder is carried over to the corporation. But the contribution to capital rule cannot apply since the court in *Broadview Lumber*\(^6\) clearly indicated that that rule does not apply in the parent-subsidiary situation. Furthermore, for the corporation to get a step-up in basis, the shareholder’s basis in the contributed property would have to be reduced, as in the brother-sister situation where the shareholder’s basis in his issuing corporation stock is reduced by his basis in the contributed stock. It is clear, however, that his basis in the stock of the parent is not reduced in the parent-subsidiary dividend equivalency situation.\(^5\) If that is the case, that is, that his basis in his shares of the parent is unchanged, then his basis in his shares of the subsidiary, if any, is not stepped-up. The corporation’s basis in contributed property reflects the shareholder’s step-up in basis in his shares of that corporation. Since the shareholder gets no step-up in basis from the contributed shares, the subsidiary’s basis in those shares must be zero.

If *Broadview Lumber*,\(^6\) holding that the subsidiary gets a cost basis, is limited to the non-dividend equivalency situation, then the Commissioner’s argument in the dividend equivalency situation must be sound. That argument\(^7\) was based on the constructive dividend theory, so that theory

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83. In the parent-subsidiary situation, the selling shareholder is not necessarily a shareholder in the acquiring corporation. Thus, it may be possible to reach the same result (that is, a zero basis in the contributed stock to the acquiring corporation) under § 362(c), dealing with nonshareholder contributions.

It is arguable, however, that the shareholder contribution rules of § 362(a) apply under § 304. The Service has held in the brother-sister situation, where the selling shareholder owned stock in the acquiring corporation only by attribution, that the sale of stock would nevertheless be treated as a shareholder contribution to capital. Rev. Rul. 77-427, 1977-2 C.B. 100.

The brother-sister situation may be distinguishable, though, because § 304(a)(1) requires control of the acquiring corporation. It would be anomalous to treat the selling shareholder as in control for purposes of § 304 but not as a shareholder for purposes of § 362(a). In the parent-subsidiary situation, no such control of the acquiring corporation is required, so it would not be anomalous to apply § 304(a)(2) and also to apply the nonshareholder contribution to capital rules of § 362(c).

84. 561 F.2d at 705-09.

85. Treas. Reg. § 1.304-3(a) (1955) (last sentence).

86. 561 F.2d 698 (7th Cir. 1977).

87. See text accompanying note 75 supra.
must be applicable in the dividend equivalency situation and the court's rejection of it must be limited to the non-dividend equivalency situation.\textsuperscript{88} If that is the case, the Service's ruling\textsuperscript{89} is correct for the dividend equivalency situation and the following tax accounting effects are incurred by the parent: (1) cash is debited and a special earnings and profits account\textsuperscript{90} is credited to reflect the hypothetical distribution from the subsidiary to the parent; (2) the entries are reversed to reflect the hypothetical distribution from the parent to its shareholder.

C. Application of Section 304 to Second-Tier Subsidiaries

In a situation involving a wholly-owned subsidiary, $Z$, of a wholly-owned subsidiary, $Y$, where $Z$ sold all of its stock in its wholly-owned subsidiary, $S$, to $Y$, the Service has ruled that section 304 is inapplicable.\textsuperscript{91} The ruling has been hailed in some circles\textsuperscript{92} while questioned in others.\textsuperscript{93} The theory behind the ruling was that control of $Y$ could not be attributed to $Z$ without attributing to $Y$ ownership of its own stock.\textsuperscript{94} The reasoning was that the only way to attribute to $Z$ the ownership of $Y$ would be first to attribute the ownership of $Y$ by its parent, $X$, to $Y$ by back attribution and then to attribute the ownership of $Y$ from $Y$ to $Z$ by back attribution. The effect of avoiding application of section 304 would be to eliminate the intercorporate 85% dividends received deduction.\textsuperscript{95}

One commentator has questioned the ruling\textsuperscript{96} because

\textsuperscript{88} See 561 F.2d at 705 n.12.

\textsuperscript{89} Rev. Rul. 69-261, 1969-1 C.B. 94. The Service has retreated from this position, however, in Rev. Rul. 80-189, 1980-29 I.R.B. 7, holding, in the dividend equivalency situation, that (1) there is no constructive dividend to the parent, and (2) the subsidiary receives a cost basis.

\textsuperscript{90} A special account must be used to avoid setting off the amount of the dividend by any deficit in the parent's earnings and profits account. The use of special accounts in connection with redemptions is explained in Nesson, \textit{Earnings and Profits Discontinuities Under the 1954 Code}, 77 Harv. L. Rev. 450, 459 (1964). See generally Marans, \textit{supra} note 2, at 175-76.

\textsuperscript{91} Rev. Rul. 74-605, 1974-2 C.B. 97.

\textsuperscript{92} Bittker & Eustice, \textit{supra} note 21, at 9-49 n.120.

\textsuperscript{93} D. Kahn & P. Gann, \textit{Corporate Taxation} 254 (1979).

\textsuperscript{94} Which would be contrary to Treas. Reg. § 1.318-1(b)(1), as amended, T.D. 6969, 1963-2 C.B. 126, which precludes a corporation from having its own stock attributed to it.

\textsuperscript{95} I.R.C. § 243(a)(1), which would not apply if the transaction were treated as what it seems to be on its face, that is, a sale.

\textsuperscript{96} D. Kahn & P. Gann, \textit{Corporate Taxation} 254 (1979).
there is no need to attribute the stock of \( Y \) to \( Y \) in order to attribute it to \( Z \).\(^{97}\) Rather, \( Y \)'s ownership of \( Z \) could first be attributed to \( X \) by beneficial-interest attribution. Then \( X \)'s ownership of \( Y \) could be attributed to \( Z \) by back attribution. \( Z \) would then get \( Y \)'s stock without any corporation having its own stock attributed to itself.

In the same vein, the ruling expresses a preference for brother-sister characterization over parentsubsidiary characterization. Alternatively, the ownership of \( Y \) could be attributed to \( S \) by adding just one more step to the chain of attribution outlined above. Once ownership of \( Z \) is attributed from \( Y \) to \( X \) by beneficial-interest attribution, ownership of \( S \) can be attributed from \( Z \) to \( X \), also by beneficial-interest attribution. Then ownership of \( Y \) can be attributed from \( X \) to \( S \) by back attribution, so that \( S \) becomes the parent of \( Y \). This is also accomplished without any corporation having its own stock attributed to it and would allow the relationship to be characterized as one of parentsubsidiary rather than as one of brother-sister.

IV. CONFLICTS WITH OTHER SECTIONS
A. Section 351

The conflict between sections 304 and 351 can be illustrated by the following simplified facts: \( X \), who owns 100\% of corporations \( A \) and \( B \), transfers part of his stock in \( A \) to \( B \) in exchange for more stock of \( B \) and other property (boot).\(^{98}\) Under section 304 the transfer qualifies as a brother-sister constructive redemption so that the boot received from corporation \( B \) will constitute a dividend to the shareholder on his \( B \) company stock. Under section 351, on the other hand, the stock from corporation \( B \) is received tax-free; gain on the transfer is recognized, but only to the extent of the boot. If the gain is less than the boot, only the gain will be taxed.

The issue is not exactly one of first impression, having been dealt with by the Sixth Circuit in the HaserotStickney series of cases\(^{99}\) and by the Ninth Circuit in *Rose Ann Coates*

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97. *See Broadview Lumber Co. v. United States*, 561 F.2d 698, 714 n.36 (7th Cir. 1977).
98. The example is taken substantially from Cohen, *supra* note 38, at 300.
99. *Commissioner v. Stickney*, 399 F.2d 828 (6th Cir. 1968), aff'g *sub. nom.* Hase-
Trust v. Commissioner. The Sixth Circuit held that section 351 takes precedence but the Ninth Circuit took the opposite view. The problem has been extensively commented upon and was at one time the subject of a House proposal which would have given legislative preference to section 304. The arguments essentially boil down to two types: those based on statutory construction and those based on policy.

The arguments based on statutory construction begin with the fact that section 304 depends for its operation on sections 301(a) and 302(d). The former section contains the language "Except as otherwise provided in this chapter," and the latter section contains the language "Except as otherwise provided in this subchapter." Section 351, so the argument goes, provides otherwise, and it is in the same chapter as 301(a) and 302(d). The Commissioner's response to the argument is that after all, a host of other sections in Chapter 1 could conceivably be applied to any redemption transaction, constructive or otherwise, and to give them precedence would be to render sections 301(a) and 302(d) nugatory. At the other extreme, the "except as otherwise provided" language could be interpreted as referring only to those sections, such as 331(b) and 346(c), which expressly refer to section 301 and/or section 302. A middle ground would be to interpret the limiting language as referring to all other distribution and redemption sections in subchapter C, thereby excluding section 351 which is neither a distribution nor a redemption section.

An attempt is also made to distinguish between a "sale" and an "exchange." It is argued that section 304 applies only when the transaction can be exclusively characterized as

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100. 46 T.C. 864 (1966), on remand from 355 F.2d 200 (6th Cir. 1965), remanding 41 T.C. 562 (1964). For an excellent review of the facts of that case see Cohen, supra note 38, at 293-94 n.29.


102. E.g., Brown, supra note 3, at 783-90; Cohen, supra note 38; Kempf, supra note 3, at 66-75; Marans, supra note 2, at 181-89.


104. See Marans, supra note 2, at 184-85.

105. See Kempf, supra note 3, at 71.

106. See id. at 70; see also Cohen, supra note 38, at 297-98 n.46.

107. See Marans, supra note 2, at 188-89.
a "sale" and that occurs only when there is no stock received in return. When such stock is so received, the transaction is characterized as an "exchange," to which only section 351 applies. The argument can be countered by pointing out, first of all, that section 304 says nothing about a "sale"; it speaks only of a corporation acquiring stock,108 and then proceeds to classify that acquisition as a redemption or distribution. Acquisition is broad enough to encompass both sales and exchanges, especially since the effect of section 304 is to recast the transaction as anything but a sale.

Closely related to this argument is the one based on the definition of property for purposes of part I of subchapter C as excluding stock in the issuing corporation.109 Since stock of the acquiring corporation is also issued in the transaction and received by the shareholder, and section 304 requires the receipt of "property," it is argued that section 304 could not apply.110 The easy answer to this is that section 304 does not require that only "property" be received, and it is conceded that the section does not apply to the receipt of the stock, though not necessarily by the operation of section 351.111 But the answer is not so easy upon further analysis. Bifurcation of a transaction is not favored in the tax law;112 why utilize section 304 which can only apply to part of the transaction when 351 will apply to the whole?

Section 351, it is argued, has been held in the past to give way to other sections of the Code, such as section 482.113 Why, then, should section 351 not also give way to section 304? The answer given is that section 482 by its terms takes precedence over all other sections.114

108. See Brown, supra note 3, at 787.
110. See Brown, supra note 3, at 787; see also Cohen, supra note 38, at 296.
111. The Commissioner in the Haserot case argued that the stock received should be treated as a stock dividend under I.R.C. § 305, rather than as having been received in exchange for the stock of the issuing corporation under I.R.C. § 351. See Marans, supra note 2, at 192.
112. Marans, supra note 2, at 185.
113. E.g., Rooney v. United States, 305 F.2d 681 (9th Cir. 1962); National Sec. Corp. v. Commissioner, 137 F.2d 600 (3d Cir. 1943). Section 482, of course, gives the Commissioner the power to reallocate income, deductions, credits and losses among related entities for the purpose of preventing tax avoidance and so as to clearly reflect income.
114. See Marans, supra note 2, at 184. The section provides that it is to apply
The legislative history is considered by some to be inconclusive. The House would have expressly made the reorganization provisions subject to the distribution sections, while the Senate in rejecting that proposal left the House version of section 304 intact. Others take a broader view of the legislative history and argue that section 351 was always intended as merely an exception to the general rule of recognition of gain on a sale or exchange. Since section 304 operates to recharacterize the transaction as something other than a sale or exchange, the general rule does not apply; hence, the exception thereto is also inapplicable.

The Commissioner has used an argument based upon the absurdity of forcing dividend treatment on a 50-80% shareholder while according exchange treatment to an 80% or greater shareholder. If anything, the 80% shareholder, who has greater control, is more likely to abuse his position by bailing out at capital gains rates the earnings and profits of one corporation by use of another corporation. It defeats the whole purpose of section 304 to extend to the 80% shareholder the privilege of exchange treatment, while denying it to a shareholder with lesser control. It may also be pointed out that giving precedence to section 351 in this case could lead to the avoidance of dividend treatment in the situation of a redemption by a corporation of its own stock. Since the definition of “property” excluding stock of the corporation applies only to part I of subchapter C, a section 351 exchange with boot could be effected if, for example, a 100% shareholder turns in 20% of his stock in the corporation for 10% of the same stock and 10% worth of boot. Therefore, an 80% or greater shareholder would, always be able to avoid dividend treatment on a redemption as long as he retains 80% control afterwards. He thus, effectively circumvents the requirements

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"[i]n any case.” I.R.C. § 482.

115. See Marans, supra note 2, at 188.
117. See Cohen, supra note 38, at 300-03.
118. Id. at 303.
119. Id. at 298-99. See also Kempf, supra note 3, at 74.
120. The tax court acknowledged this argument when it recognized that “greater control (with concomitant greater power for mischief) may confer the benefits of capital gains treatment.” Haserot v. Commissioner, 41 T.C. at 570.
A number of alternative resolutions of the conflict between sections 304 and 351 have been suggested. One possibility is to apply section 351 to the receipt of stock and section 304 to the receipt of boot, which is the position adopted by the Ninth Circuit. Another alternative is to apply section 304 to the boot and section 305 (stock dividends) to the stock. This latter suggestion was argued by the Commissioner. This approach might lead to the tax-free receipt of the stock even for shareholders without 80% control. The possibility also exists of integrating sections 304 and 351, with section 304 to be applied to characterize the gain recognized by section 351(b) as ordinary income. A fourth alternative is to bypass section 304 altogether and apply section 301 directly to the receipt of boot, treating it as a distribution on the stock of the acquiring corporation. All of the basis of the stock transferred to the corporation would be allocated to the stock of the corporation received in exchange, so that if that basis is more than the fair market value of the stock received, the

121. See generally Marans, supra note 2, at 189-97.
122. Id. at 191-92. Marans also suggests an integrated § 304 § 351 approach, under which the amount to be taxed would be determined under § 351(b), while § 304 would apply to tax that amount as ordinary income. He criticizes that approach as illogical, for if § 304 applies at all, it would be to characterize the boot as a distribution on the stock retained, not as received in exchange for the stock given up. As such, the entire amount of the boot must be available for taxation, rather than limiting the tax to the amount of the gain in all cases. Marans, Section 304: The Shadowy World Revisited, 22 Tax L. Rev. 721, 722-23 (1967).
123. Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir.), cert. denied, 414 U.S. 1045 (1973), aff'g 55 T.C. 501 (1970). In that case no stock, but only a long-term note, was received by the selling shareholders. The tax court, in fact, originally held section 351 inapplicable by not characterizing the note as a security. The Ninth Circuit, however, squarely faced the issue and found section 304 to supersede. See Brown, supra note 3, at 788-90. The lesson to be learned is that no one, the Commissioner or the taxpayer, should take a case to court with bad facts.
124. Marans, supra note 2, at 192-94.
125. Id. at 192.
126. Id. at 193-94.
127. See note 122 supra.
128. In an appropriate situation, the Service may characterize the boot as a § 301 distribution from the issuing corporation. See Rev. Rul. 80-239, 1980-36 I.R.B. 7 (boot received from acquiring corporation, financed by loan which was guaranteed by issuing corporation and repaid with dividends from issuing corporation, treated as received from issuing corporation).
129. Marans, supra note 2, at 194-95.
amount of the boot to be treated as a dividend will be reduced. That would make this fourth alternative preferable to the individual taxpayer over the first alternative, which would allocate the basis of the stock transferred between the stock received and the boot, with the result that the full amount of the boot would be treated as a dividend. Of course, if the value of the stock received exceeds the basis of the stock transferred, it would be preferable to have section 304, rather than section 301, apply, since if section 304 applies, only the amount of the boot will be treated as a dividend, while if section 301 applies, the entire gain, even that part attributable to the stock received, will be treated as a dividend.

So, if the boot is treated under section 351(b), the lesser of the gain or the boot will be recognized. If it is treated under section 304, the amount of the boot will always be recognized. If, on the other hand, it is treated under section 301, the amount of the gain will always be recognized.

To add yet another voice to the chorus, it is submitted that an argument might be made that section 304 treatment of the boot received is provided for by the Code. First, it must be recognized that section 304 does not come into conflict at all with section 351(a). Section 351(a) covers the situation in which only stock or securities are received in exchange for property transferred to the corporation. While the receipt of securities could be covered by section 304, it will, for simplicity, be assumed that only stock is received. Section 304, on the other hand, requires that "property" be received from the corporation, and the stock of the corporation is excluded.

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130. See id.

131. See Treas. Reg. §1.351-2(d) (1955) for the suggestion that stock received in a section 351 exchange could be taxed as a dividend when its receipt has the effect of the receipt of a taxable dividend.

132. This was the posture of the conflict in Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir.), cert. denied, 414 U.S. 1045 (1973), aff'd, 55 T.C. 501 (1970). See note 124 supra.

133. The assumption by a newly formed acquiring corporation of the liability of the transferor, incurred in the acquisition of the stock transferred to the acquiring corporation, has been held by the Service not to constitute "property" received from the acquiring corporation. Rev. Rul. 80-240, 1980-36 I.R.B. 8. The ruling took note of the fact that there were nontax reasons for the acquiring corporation to have acquired the stock through the shareholder, rather than directly. As such, the ruling's conclusion was based on treating the shareholder as a mere agent for the acquiring corporation.
from the definition of the term "property" by section 317(a). Thus, as long as only stock is received, that is, as long as section 351(a) is applicable, there is no conflict with section 304. The conflict arises only when property other than stock (assuming no securities are received) is received from the corporation. When that is the case, section 351(b) controls. That section, by its terms, applies only when section 351(a) would apply but for the fact that property is received which is not permitted to be received thereunder. Accordingly, if there is any other reason for section 351(a) not to apply, apart from the fact that something other than stock (or securities) is received, section 351(b) will not apply. When the property transferred to the corporation is stock of another corporation, then, aside from the fact that impermissible property is received, section 351(a) does not apply because impermissible property is transferred, that is, property the transfer of which may lead to a different result under section 304. Therefore, section 351(a) would not apply but for the fact that impermissible property is received. By its express terms section 351(b) would not apply to the section 304 situation. As such, there is no conflict with section 304.

In the section 351(a) situation where only stock is received, section 304 is rendered inapplicable. In the section 351(b) situation where property other than stock or securities is received, section 351(b) is rendered inapplicable. Since it is that latter section, dealing with the boot, that section 304 renders inapplicable, and not section 351(a) dealing with the stock, section 304 can apply only to the boot and not to the stock. Therefore, it follows that the full amount of the boot is treated as a redemption to be tested under section 302(b), regardless of the amount of the gain.

B. "D" Reorganizations

To illustrate this area of potential conflict, consider the following example: X, an 80% shareholder in corporation A, pursuant to a plan of reorganization, sets up another corporation, B, in which he owns 100% of the stock. Corporation A sells all of its assets to corporation B and liquidates, distributing to X his share of the proceeds.134 The situation fits all the

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134. These were substantially the facts in Liddon v. Commissioner, 230 F.2d 304
elements of a "D" reorganization, namely: (1) a transfer by a corporation of all or part of its assets to another corporation; (2) shareholders of the transferor corporation controlling (80% or more of) the transferee corporation; and (3) a distribution of stock in the transferee corporation pursuant to a plan of reorganization.\footnote{135}

With a little ingenuity an attempt can be made to recast the transaction as a section 304 redemption. If the sale of assets by corporation $A$ to corporation $B$ can be equated with a sale of stock of $A$ to $B$, with the distribution deemed to be coming from $B$ rather than $A$, the elements of section 304 are satisfied.\footnote{136} To recast the sale of assets as a sale of stock would require no more than the reverse of the reasoning applied in Kimbell-Diamond Milling Co. v. Commissioner.\footnote{137}

The difference in treatment depending upon which characterization is adopted can be substantial. Section 356(a)(2) provides for dividend treatment of boot received in a reorganization. However, the effect of such treatment is ameliorated in the following ways: (1) only the gain recognized in the reorganization exchange will receive dividend treatment; (2) that gain will be so treated only to the extent of accumulated earnings and profits\footnote{138} and only to the extent of the shareholder's ratable share thereof. Under section 304, on the other hand, the entire amount of boot received is eligible for dividend treatment, to the full extent of all the acquiring corporation's earnings and profits, both accumulated and current.

Although the acquiring corporation is newly organized, and therefore has no earnings and profits, it may nevertheless be possible to accord dividend treatment to the distribution under section 304. The acquiring corporation is deemed to be making the distribution of boot under the recharacterization of the transaction. By further recharacterizing the transaction, the acquiring corporation may also be deemed to have re-

\footnotesize{(6th Cir.), cert. denied, 352 U.S. 824 (1956) in which a "D" reorganization was found. See generally Kempf, supra note 3, at 75-81. See also note 148, infra.}
\footnote{135. Kempf, supra note 3, at 78.}
\footnote{136. See id. at 83-84 for the suggestion that Kimbell-Diamond could be extended to convert a sale of assets to a sale of stock. See also Marans, supra note 2, at 195-96.}
\footnote{137. 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951).}
\footnote{138. See Brown, supra note 3, at 793.
deemed its stock in the issuing corporation (deemed to have been received in place of the assets) in exchange for the boot needed to make the distribution. This is in accord with the substance of the transaction, because otherwise, its absence of ownership of the stock of the issuing corporation could not be accounted for, nor could its receipt of the boot needed to make the distribution. With the transaction so recharacterized, the acquiring corporation's earnings and profits would be increased, at least in the amount of the gain on the reorganization exchange. Thus, the limitations on dividend treatment based on the inclusion of only accumulated earnings and profits and the shareholder's ratable share thereof would not apply.

The commentators, however, seem to concur that section 304 would give way to the reorganization provisions in a case like the aforementioned. Their application is more direct, more comprehensive, and they expressly contemplate dividend treatment. It has been suggested, however, that if a new corporation is soon thereafter set up to take the place of the old, the preference for the reorganization provisions may diminish.

C. Partial Liquidations

A partial liquidation under section 346(b) requires that the corporation close out an entirely separate business which it had previously been operating. Two situations must be distinguished in this area. In the first, a subsidiary is partially liquidating and the shareholders of the parent realize the proceeds thereof by selling stock of the parent to the subsidiary. A section 304 characterization would consider the corporation as not redeeming its own stock. On the other hand, a section 346 characterization would reflect the fact that the corporation making the distribution is partially liquidating, and it is only through a fiction that the distribution would be considered as coming from the parent under section 304.

The commentators seem to agree that section 304 would

139. I.R.C. § 312(f)(1).
140. Kempf, supra note 3, at 82; Marans, supra note 2, at 207.
141. Kempf, supra note 3, at 82-83.
142. See generally Brown, supra note 3, at 790-92.
143. See Marans, supra note 2, at 201-02.
clearly give way here. Where this is not so obvious, however, is in the situation where it is the parent which is partially liquidating and its shareholders sell their stock to the subsidiary. In that case, the corporation actually making the distribution is neither redeeming its own stock nor is it partially liquidating. Most of the authorities advise that section 304 treatment is likely, although it is suggested that in the situation of non-dividend equivalency under the tests of section 302(b), treatment under section 304 would be only slightly less innocuous under these circumstances than treatment under section 346(a).

D. Liquidation-Reincorporation

The pattern here, which has been presented to the courts on a number of occasions, is basically as follows: X, who controls corporation A, has A adopt a plan of complete liquidation pursuant to section 337. X sets up a new corporation, B, in which X retains only 75% control and either has corporation A sell its assets to corporation B and distribute the cash in liquidation or distribute its assets in liquidation to X who sells them to corporation B. This resembles a “D” reorganization, except for the fact that X does not control the transferee corporation. By the simple expedient of retaining less than 80% control, X avoids the dividend treatment of section 356(a)(2), and apparently is entitled to section 346(a).

144. Brown, supra note 3, at 790; Marans, supra note 2, at 202.
145. See Marans, supra note 2, at 201.
146. Id.
148. E.g., Joseph C. Gallagher, 39 T.C. 144 (1962); Cramer v. Commissioner, 20 T.C. 679 (1953). See generally Lane, The Reincorporation Game: Have the Ground Rules Really Changed?, 77 Harv. L. Rev. 1218 (1964). Recent cases have dealt with the liquidation-reincorporation problem by holding the purported liquidation to be a "D" reorganization. This result has been accomplished by stretching the definition of a "D" reorganization, particularly the "substantially all" requirement of § 354(b)(1)(A). See Simon v. Comm'r, 644 F.2d 339 (5th Cir. 1981); Smothers v. United States, 642 F.2d 894 (5th Cir. 1981); Atlas Tool Co. v. Comm'r, 614 F.2d 860 (3rd Cir.), cert. denied, 101 S. Ct. 110 (1980); Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967); Moffat v. Comm'r, 363 F.2d 262 (9th Cir. 1966), cert. denied, 386 U.S. 1016 (1967).
149. As defined, for purposes of part III of subchapter C, in I.R.C. § 368(c), which requires at least 80% control.
However, recasting the sale of assets as sale of stock in the liquidating corporation by the shareholder to the transferee corporation, the transaction can be made to fit the requirements of section 304, in the same way as suggested for the "D" reorganization. The arguments against having section 304 take precedence over the reorganization provisions do not apply here with equal force. Although the liquidation provisions are comprehensive, they do not contemplate dividend treatment as do the reorganization provisions.

As suggested earlier, the sale of assets rather than stock problem could be surmounted with a reverse Kimbell-Diamond argument. A more difficult problem is presented by the fact that section 331 expressly excludes the application of section 301. To counter this problem the Commissioner would have to argue that the liquidation was nothing more than a sham, so that section 331 would not apply.

If section 304 treatment were accorded the transaction, the amount of the dividend would be measured by the newly formed acquiring corporation's earnings and profits. Given this treatment, it has been suggested that the corporate relationship be recast as that of parent-subsidiary. In view of our earlier discussion of the implications of Broadview Lumber, such a characterization would seem unlikely. However, the suggestion made earlier in the section on "D" reorganizations (that a redemption by the issuing corporation from the acquiring corporation of the issuing corporation's stock could be hypothesized, giving the acquiring corporation earnings and profits in the amount of the reorganization gain), may be applicable here as well, thus giving the acquiring corporation earnings and profits in the amount of the liquidation gain.

Other commentators have suggested that there is little evi-
idence that Congress intended section 304 to be so broad.\footnote{157} That may be, but there is nothing to stop the Commissioner from trying to so stretch the section. Therefore, section 304 certainly is a tax planner's nightmare.\footnote{158}

\footnote{157. Marans, \textit{supra} note 2, at 203-05.}
\footnote{158. \textit{Id.} at 216.}