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Taxation of Boot in Corporate Reorganizations: Resolution of the Wright-Shimberg Debate - Commissioner v. Clark

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TAXATION OF "BOOT" IN CORPORATE REORGANIZATIONS: RESOLUTION OF THE *Wright-Shimberg* DEBATE

Commissioner v. Clark,
109 S. Ct. 1455 (1989)

I. INTRODUCTION

In a corporate reorganization, stockholders of an acquired corporation may receive stock of the acquiring corporation plus additional money or property, commonly referred to as "boot," in exchange for their stock in the acquired corporation. The taxpayer may have realized a gain on the stock-for-stock exchange, but this gain is not recognized for tax purposes.[1] However, if the taxpayer realizes a gain on the non-qualifying consideration (the boot) he must recognize the gain.[2] Although the question arises whether to characterize the gain as ordinary income or capital gain, characterization of the gain does not appear to be as important after 1986 with the repeal of section 1202[3] from the tax code. Section 1202 accorded capital gains a preferential treatment in the form of a 60% deduction on gain from the sale or disposition of a capital asset.[4] However, for reasons to be discussed later in this note, characterization of gain as ordinary or capital remains relevant. Until the United States Supreme Court decision of *Commissioner v. Clark*,[5] the question whether to characterize boot as ordinary or capital filtered through the federal circuits with different results. This note will outline the various approaches of the circuit courts, discuss *Clark*'s significance in resolving the issue, and explain the continuing relevance of the ordinary/capital distinction.

II. FACTS

Donald Clark, president of Basin Surveys, Inc. (Basin) from 1964 until April, 1979, owned all the outstanding shares (58) of Basin stock.[6] N.L. Industries, Inc. (N.L.), a publicly owned corporation interested in a possible acquisition of Basin, made Clark alternative offers for his Basin stock.[7] Clark was given an option to exchange his Basin stock either for 425,000 shares of N.L. common stock or for

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1. I.R.C. § 354(a)(1) (1986). Unless otherwise specified the 1986 Code sections herein cited are identical to the 1954 Code sections under which *Clark* was decided.

2. I.R.C. § 356(a)(1)(B) (1986).

3. I.R.C. § 1202 (1984).

4. *Id.*

5. 109 S. Ct. 1455 (1989).

6. *Id.* at 1459.

7. *Id.*

300,000 shares of N.L. common stock plus $3,250,000.[8] Clark agreed to the second offer, and the transaction was consummated in April, 1979.[9]

In April, 1979, a forward triangular merger was completed in which Basin merged with N.L. Acquisition Corp. (NLAC), an N.L. subsidiary founded to effectuate the acquisition.[10] The gain on the exchange of Basin stock for N.L. stock was not recognized for tax purposes since the transaction qualified under sections 368(a)(1)(A) and (a)(2)(D)[11] as a nontaxable reorganization.[12] A question arose, however, whether to characterize the $3,250,000 cash boot, which is non-qualifying consideration, as ordinary or capital gain.[13]

Clark reported the $3,250,000 on his 1979 tax return as capital gain.[14] The Commissioner of Internal Revenue disagreed with Clark's characterization of the boot as capital gain[15] and assessed a $972,504.74 deficiency against Clark. Clark petitioned the Tax Court for review. The Commissioner argued that the boot had the "effect of the distribution of dividend"[16] and therefore was taxable as ordinary income "to the extent of Clark's ratable share in Basin's earnings and profits."[17]

The Tax Court unanimously held that Clark was entitled to capital gains treatment.[18] The Commissioner appealed the Tax Court's decision to the Fourth Circuit Court of Appeals which affirmed the Tax Court's decision.[19] The Commissioner then appealed the Fourth Circuit's affirmation of the Tax Court's decision to the United States Supreme Court. Agreeing that the $3,250,000 boot was entitled to capital gains treatment, the Supreme Court affirmed.[20]

III. HISTORY AND BACKGROUND

The issue in *Clark* has been before several federal courts with differing results. The United States Supreme Court was presented not only with conflicting decisions of federal circuit courts, but also with an Internal Revenue Code open to numerous interpretations as to when and how to tax boot. An understanding of the conflicting federal decisions and the Code provisions involved is imperative to an understanding of the *Clark* decision.

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8. *Id.*

9. If Clark had accepted the 425,000 shares of N.L. stock, he would have held approximately 1.3% of N.L. common stock outstanding. Under the deal Clark accepted, the 300,000 shares represented .9290% of N.L. outstanding common stock. Clark v. Commissioner, 86 T.C. 139 (1986).

10. Clark v. Commissioner, 828 F.2d 221, 222 (4th Cir. 1987).

11. I.R.C. § 368(a)(1)(A) (1986).

12. I.R.C. § 354(a)(1) (1986).

13. *Clark*, 109 S. Ct. at 1459.

14. *Id.*

15. *Id.*

16. *Id.*

17. *Clark*, 828 F.2d at 223 (4th Cir. 1987).

18. *Clark*, 109 S. Ct. at 1459.

19. *Id.* at 1461.

20. *Id.* at 1466.

A. The Code

1. Section 301 – Distributions

The *Clark* Court focused on the language of section 356(a)(2) which provided that boot would be taxed as ordinary income in a reorganization if the exchange of stock and boot had "the effect of the distribution of a dividend."[21] To determine if an exchange pursuant to a plan of reorganization had the effect of the distribution of a dividend, a walk through the code sections dealing with distributions and dividends is helpful.[22]

Section 301 specifies that when a corporation distributes property to its shareholders with respect to its stock,[23] the portion of the distribution which constitutes a dividend is included in the shareholder's income.[24] Section 316(a)[25] contains a two-part definition of dividend. If the corporation distributes property to its shareholders out of its accumulated or current earnings and profits, the corporation has given a dividend to its shareholders. A distribution which comes out of the corporation's accumulated[26] and/or current earnings and profits reflects the corporation's success;[27] therefore, distribution is properly determined to be a dividend upon which the shareholders must include in gross income since this dividend reflects their share in the corporation's success.[28] If, however, the corporation has no earnings and profits, any distribution it makes cannot logically be characterized as a dividend. Distributions of property by a corporation under these circumstances more closely resemble a return of capital to the shareholders and thus should not be includable in a shareholder's gross income.[29]

Determination of whether a corporate distribution is a return of capital or a dividend is geared to the existence of corporate earnings and profits.[30] While not specifically defined in the tax code,[31] the concept of earnings and profits is important. Section 312 of the tax code[32] provides for certain adjustments to earnings and profits but never specifies exactly what constitutes earnings and profits. Earnings and profits are sometimes confused with, and used synonymously with, corporate surplus; however, earnings and profits are not identical to surplus.[33] If earnings and profits were allowed to be determined as the amount of corporate surplus, the

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21. *Id.* at 1462.

22. *See generally* B. BITTKER & J. EUSTICE, FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS §§ 7.01-7.02 (5th ed. 1987) [hereinafter BITTKER & EUSTICE].

23. I.R.C. § 301(a) (1986).

24. I.R.C. § 301(c)(1) (1986).

25. I.R.C. § 316(a) (1986).

26. *Id.*

27. *See generally* BITTKER & EUSTICE, *supra* note 22, at § 7.01.

28. *Id.*

29. *Id.*

30. I.R.C. § 316(a) (1986).

31. BITTKER & EUSTICE, *supra* note 22, at § 7.03.

32. I.R.C. § 312 (1986).

33. BITTKER & EUSTICE, *supra* note 22, at § 7.03.

corporation could declare a stock dividend, which would deplete the surplus, and then distribute cash tax free.[34]

Earnings and profits have also been confused with the corporation's taxable income,[35] but sometimes non-taxable income is a valid addition to earnings and profits.[36] The rationale behind not finding a dividend where there are no earnings and profits is to prevent a tax on a mere return of capital; however, because distribution of income which is not taxable does not invade the corporation's capital,[37] there is no correlative reason to exclude such income from earnings and profits.

2. Section 356 – Reorganizations

Section 356 of the 1986 Internal Revenue Code governs the taxation of boot received in corporate reorganizations. Section 356(a)[38] provides that if, in addition to stock which meets section 354 nonrecognition treatment, the taxpayer receives nonqualified consideration, the taxpayer must recognize the gain, if any, and pay tax on it, but not in excess of the value of the boot.[39] The character of the gain is determined under section 356(a)(2)[40] which provides:

> If an exchange is described in paragraph (1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)) [dealing with constructive ownership of stock], then there shall be treated as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be treated as gain from the exchange of property.[41]

If the boot did not have the effect of the distribution of a dividend, the recognized gain will be treated as gain from the exchange of property capital gain if the stock transferred would have been a capital asset in the shareholder's hands.[42] If it is determined that the boot had the effect of a dividend distribution, the gain on the boot must be recognized as ordinary income up to each share's allocable portion of the corporation's undistributed accumulated earnings and profits.[43] Any remaining gain is treated as capital gain from the exchange of property.[44] This is the "dividend within gain" concept of section 356(a)(2).[45] For example, if a taxpayer realized a $500 gain on an exchange in which he received stock worth $250 and $250 cash boot, he must recognize and pay tax on the $250 cash boot. If, how-

34. *Id.*
35. *Id.*
36. *Id.*
37. *Id.*
38. I.R.C. § 356(a) (1986).
39. *Id.*
40. I.R.C. § 356(a)(2) (1986).
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.*
45. BITTKER & EUSTICE, *supra* note 22, at § 14.34.

ever, the taxpayer did not realize a gain because his basis in the stock he traded was $500, then he will not have dividend income.[46]

Section 356 does not reveal the circumstances that would render boot as having the effect of a dividend, but some courts have read this section as requiring that pro rata distributions made pursuant to corporate reorganizations be taxed as dividends if the acquired corporations had undistributed earnings and profits.[47] This is the automatic dividend rule.[48] However, other courts have argued that section 356 does not expressly adopt this automatic dividend rule and that if Congress had intended this construction it would simply have stated that all property accompanying stock in a corporate reorganization is taxable as a dividend if the corporation had undistributed earnings and profits.[49]

After the Tax Court decided *Clark* (but before the Supreme Court disposition), the Senate Finance Committee proposed changes to section 356 which would clarify boot characterization.[50] The finance committee suggested that determination of whether a boot distribution has the effect of a dividend should be made as though the taxpayer received only stock in the exchange and then redeemed part of it when the reorganization was completed.[51] Congress declined to adopt this revision and amend section 356 in the 1986 Tax Code. Congress had another opportunity to amend section 356 in 1987, but again did not do so. An explanation has been advanced that with the repeal of section 1202 in 1986, Congress did not think that characterizing gain as capital or ordinary remained important.[52]

3. Section 302 – Redemptions

Section 302 of the 1986 Code governs taxation of stock redemptions. Section 302(a) provides that if a corporation redeems its stock the redemption will be "treated as a distribution in part or full payment in exchange for the stock"[53] as long as 302(b)(1), (2), (3), or (4) applies.[54] The corporation redeems its stock when it exchanges property for its shareholder's stock.[55] If the redemption does not comply with 302(b)(1), (2), (3), or (4), then it will be taxed as a section 301 distribution[56] (i.e., the redemption will be taxed as a dividend[57] to the extent of the

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46. *Id.*

47. *See* Commissioner v. Estate of Bedford, 325 U.S. 283 (1945); Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979); Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934).

48. *See Bedford*, 325 U.S. 283 (1945) (taxpayer accorded dividend treatment because the corporation had undistributed earnings and profits).

49. Idaho Power Co. v. United States, 161 F. Supp. 807, 809 (Ct. Cl.), *cert. denied*, 358 U.S. 832 (1958).

50. S. Rep. No. 47, 99th Cong., 1st Sess. (1985).

51. *Id.*

52. Knotts, *The Characterization of Boot Distributions in Corporate Reorganizations After 1986*, 66 Taxes 387, 396 n.104 (1988).

53. I.R.C. § 302(a) (1986).

54. *Id.*

55. I.R.C. § 317(b) (1986).

56. I.R.C. § 302(d) (1986).

57. I.R.C. § 301(c) (1986).

corporation's accumulated or current earnings and profits).[58] Section 302(b) describes four situations in which redemption will be held to be a capital transaction and, were it not for the repeal of section 1202, eligible for capital gains treatment.

Under section 302(b)(1), if a redemption is not "essentially equivalent to a dividend"[59] it will qualify for exchange treatment under section 302(a).[60] The Code, however, makes no attempt to define in what situations a redemption will not be equivalent to a dividend. The United States Supreme Court looked at this provision and held that if the stockholder experienced a "meaningful reduction" in his proportionate interest in the corporation, the redemption could not have been equivalent to a dividend;[61] however, there are no hard and fast rules which indicate when a redemption will be held to have dividend equivalency. Because of the ambiguity in the application of section 302(b)(1), it should only be utilized if the other section 302(b) tests fail.[62]

Section 302(b)(2) has been cited as a "safe harbor" provision.[63] The section specifies that a redemption will receive exchange treatment under section 302(a) if the distribution is "substantially disproportionate" to the shareholder[64] and if the shareholder owns less than 50% of the corporation's voting stock immediately after the redemption.[65] Section 302(b)(2)(C) states that a distribution will be substantially disproportionate if the shareholder's post-redemption percentage of voting stock is less than 80% of the shareholder's pre-redemption percentage of voting stock.[66] This test is an objective, mathematical test. If a redemption does not satisfy the section 302(b)(2) provisions, it is not within the safe harbor and must therefore qualify under one of the remaining section 302(b) tests. The substantially disproportionate language has been interpreted and applied in a number of redemption cases.[67]

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58. I.R.C. § 316(a) (1986).

59. I.R.C. § 302(b)(1) (1986).

60. *Id.*

61. United States v. Davis, 397 U.S. 301, 313, *reh'g denied*, 397 U.S. 1071 (1970).

62. BITTKER & EUSTICE, *supra* note 22, at § 9.02.

63. I.R.C. § 302(b)(2)(A) (1986).

64. *Id.*

65. I.R.C. § 302(b)(2)(B) (1986).

66. I.R.C. § 302(b)(2)(C)(i)-(ii) (1986). An example of an application of the "substantially disproportionate" standard appears in Treas. Reg. § 1-302-3(b) as follows:

> Example: Corporation M has outstanding 400 shares of common stock of which A, B, C and D each own 100 shares or 25 percent. No stock is considered constructively owned by A,B,C or D under section 318. Corporation M redeems 55 shares from A, 25 shares from B, and 20 shares from C. For the redemption to be disproportionate as to any shareholder, such shareholder must own after the redemptions less that 20 percent (80 percent of 25 percent) of the 300 shares of stock then outstanding. After the redemptions, A owns 45 shares (15 percent), B owns 75 shares (25 percent), and C owns 80 shares (26 2/3 percent). The distribution is disproportionate only with respect to A.

67. Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976), *aff'd*, 592 F.2d 1251 (5th Cir. 1979) (taxpayer's voting stock, reduced from 72% to 49%, was a substantially disproportionate distribution within the meaning of § 302(b)(2)); Commissioner v. Berenbaum, 369 F.2d 337 (10th Cir. 1966) (a redemption of shareholder's non-voting preferred stock did have dividend equivalence because taxpayer still owned controlling shares of voting stock and there was no substantially disproportionate reduction in his control of the corporation); *see also* Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962).

There are two remaining tests under section 302(b) which, if met, would confer exchange treatment when the corporation redeems the shareholder's stock. Section 302(b)(3) accords exchange treatment to the corporation's redemption of all the shareholder's stock while section 302(b)(4) allows exchange treatment when the redemption is made from a noncorporate shareholder in partial liquidation. Neither of these provisions applies in *Clark* since Clark's interest in N.L. was not totally terminated and since the redemption was not made pursuant to a partial liquidation of N.L.

4. *In Pari Materia* Application of Sections 302 and 356

As a result of section 356's silence on when an exchange will have "the effect of the distribution of a dividend," courts began to use section 302 redemption principles to determine whether an exchange in a corporate reorganization had the effect of a dividend distribution. An early case, *Kirschenbaum v. Commissioner,*[68] looked to section 302(b)(1) and recognized that "[w]hether the distribution of accumulated earnings 'has the effect of the distribution of a taxable dividend,' is surely the same question as whether such a distribution is 'essentially equivalent to the distribution of a taxable dividend.' "[69]

Other courts, while not expressly stating that these two sections are read *in pari materia,* have based their decisions on an assumption that the section 302(b)(2) substantially disproportionate test can be applied to determine whether a distribution made pursuant to a corporate reorganization had the effect of a dividend distribution under section 356(a)(2).[70]

The court in *Idaho Power Co. v. United States,*[71] compared the "effect of the distribution of a dividend" language of section 356(a)(2) with the "essentially equivalent to a dividend" language of section 302(b)(1).[72] Deciding that both provisions were designed to prohibit distributions from being characterized as capital transactions if they were in reality dividends,[73] the court thus concluded that section 302(b) principles would apply in section 356 reorganizations. The court then held that, in determining dividend equivalence under section 302(b)(1), if the shareholder has substantially the same interest in the corporation after the distribution as he had before the distribution, then the distribution is essentially equivalent to a dividend.[74] Applying the substantially disproportionate standard of section 302(b)(2) to the section 356 reorganization at issue in the case before it the *Idaho Power* court found that the taxpayer's reduction in interest caused by the reorgani-

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68. 155 F.2d 23 (2d Cir. 1946).

69. *Id.* at 24.

70. *See* Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956) (release from indebtedness in a corporate reorganization resulting in taxpayer's receiving less stock from surviving corporation was not a reduction of interest sufficient to render the transaction substantially disproportionate and therefore had the effect of a dividend distribution).

71. 161 F. Supp. 807 (Ct. Cl. 1958).

72. *Id.*

73. *Id.* at 809.

74. *Id.* at 810.

zation was sufficient to avoid invocation of dividend equivalence.[75] It is important to note that for exchange treatment to be rendered under section 302(a), either section 302(b)(1) or section 302(b)(2) would suffice. The court in *Idaho Power* used the section 302(b)(2) substantially disproportionate standard to find that there was no dividend equivalence under section 302(b)(1).

In *Ross v. United States*,[76] the Court of Claims stated that "[t]he phrase 'has the effect of the distribution of a dividend' in [section] 356 and its predecessor [section 112 of the 1939 Tax Code] is *in pari materia* with the phrase 'essentially equivalent to a dividend' as used in [section] 302[(b)(1)] and its predecessor [section 115 of the 1939 Tax Code]."[77] The *Ross* court was the first to expressly state that 302(b)(1) and 356(a)(2) were to be read *in pari materia*.

In 1974, the Internal Revenue Service followed *Ross* by deciding that the section 302(b) tests for characterizing a redemption as an exchange or as a dividend may serve as guidelines for determining if a distribution had the effect of a dividend distribution in section 356 reorganizations.[78] Thus, there is authority for the proposition that the section 302(b) tests may be utilized for determining whether a distribution made pursuant to a corporate reorganization warrants exchange treatment.

B. The Automatic Dividend Rule

In *Commissioner v. Estate of Bedford*[79] the United States Supreme Court had the opportunity to interpret and apply section 112 (the 1936 Internal Revenue Code equivalent to section 356) in its consideration of whether boot received in a plan of recapitalization was taxable as capital gain or as ordinary income. Central to the issue was whether the boot had the "effect of the distribution of a dividend." The Court stated that a dividend is defined by statute as "any distribution made by a corporation to its shareholders . . . out of its earnings and profits."[80] The corporation which recapitalized in *Bedford* admittedly had earnings and profits in excess of the amount of cash that it distributed to its shareholders. The Supreme Court concluded that since the corporation had these earnings and profits the "cash therefore came out of earnings and profits and such a distribution would normally be considered a taxable dividend."[81] Since "a distribution out of accumulated earnings and profits is a 'dividend' . . . [it follows that] a distribution of earnings and profits has the 'effect of the distribution of a taxable dividend'. . . ."[82] The

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75. *Id.*

76. 173 F. Supp. 793 (Ct. Cl.), *cert. denied*, 361 U.S. 875 (1959).

77. *Id.* at 797.

78. Rev. Rul. 74-516, 1974-2 C.B. 121.

79. 325 U.S. 283 (1945).

80. *Id.* at 290-91 (quoting I.R.C. § 115(a) (1936)). *See* I.R.C. § 316(a)(1) (1986).

81. *Id.*

82. *Id.* at 292.

Court therefore held that the boot received by the taxpayer was taxable at ordinary income rates.[83]

Bedford has been cited by subsequent courts as the "automatic dividend" rule because any time a distribution is made to stockholders pursuant to a corporate recapitalization or reorganization when the corporation had undistributed earnings and profits, the distribution would have the effect of a dividend and thus not be entitled to capital gains treatment.

1. Withdrawal from the *Bedford* Rule

Bedford has been severely criticized for various reasons by courts faced with determining dividend equivalency in corporate reorganizations.[84] One reason courts have been reluctant to apply the automatic dividend rule is that it does not allow the court to look into the motivation for the reorganization: The rule only looks to whether the acquired corporation had earnings and profits.

In *King Enterprises, Inc. v. United States*,[85] which rejected the *Bedford* Court's finding that dividend equivalency was automatically present where earnings and profits existed,[86] the court stated that "[t]he operative words of section 356(a)(2) suggest a test of 'dividend equivalence', rather than a conclusion of automatic dividend income merely because of the existence of earnings and profits . . . ."[87] If dividend equivalency was not to be found automatically upon the existence of earnings and profits, courts would have to find an alternative method to determine whether a boot payment would have the effect of a dividend distribution.

2. An Alternative to the *Bedford* Rule

An *in pari materia* reading of section 356(a)(2) and section 302(b)(2) would render a boot payment as having the effect of a dividend distribution unless the stockholder meets the safe harbor provision of section 302(b)(2). Therefore, for a boot payment to receive exchange treatment, the taxpayer must own less than 50% of the voting stock and must meet the substantially disproportionate standard set forth in section 302(b)(2)(C). If section 356(a)(2) is read *in pari materia* with section 302(b)(1), a court will have to determine when a distribution is essentially equivalent to a dividend before it can decide if a boot payment has the effect of a dividend distribution. But, as has previously been stated in this note,[88] the courts are not clear as to how this determination should be made even though they agree that they should look to the facts and circumstances of each case in deciding

83. *Id.*

84. Wright v. United States, 482 F.2d 600 (8th Cir. 1973); King Enters. v. United States, 418 F.2d 511 (Ct. Cl. 1969).

85. 418 F.2d 511 (Ct. Cl. 1969).

86. *Id.* at 520.

87. *Id.*

88. *See supra* note 61 and accompanying text.

whether or not a distribution is equivalent to a dividend.[89] Factors to which courts look include the following:

> The presence or absence of a bona fide corporate business purpose, whether the initiative for the distribution came from the corporation or from the participating stockholders, whether earnings and profits were available for dividends and the prior dividend history of the company, whether the transaction resulted in any substantial change in the ownership or control of the corporation, whether the transaction was the result of or resulted in a contraction of the corporation's business or narrowed its activities, whether the distribution was substantially pro rata among the stockholders, and whether the stock acquired by the corporation was canceled and retired or held as treasury stock.[90]

The presence of all of these factors in one case is unlikely and, in fact, unnecessary. Some factors will weigh more heavily than others, but there is no clear-cut test for how many of the factors must be present for a finding that there is no dividend equivalence. The "net effect" of the factors will be considered.[91] For example, courts have held that a bona fide business purpose is insufficient, absent other factors, to insulate the stockholders from receiving dividend treatment.[92]

One factor which does weigh heavily in determining whether a distribution is equivalent to a dividend is the stockholder's interest in and control of the corporation after the reorganization.[93] Since the purpose of a statutory reorganization is to allow a stockholder to retain a continuing interest in the post-reorganization enterprise, "[a]n important indicium of equivalence of a payment to a dividend is present if, after the exchange of stock and the payment, the shareholder still has the same or substantially the same interest in the corporation after the payment that he had before."[94]

C. *The "Meaningful Reduction" Test*

In stock redemption cases, courts have consistently held that if a redemption of stock results in a meaningful change in the stockholder's position in the corporation as compared with the other shareholders, then the money he has received is not equivalent to a dividend.[95] If the stockholder does not experience a significant

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89. Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (involving a redemption). *See* Ross v. United States, 173 F. Supp. 793, 797 (Ct. Cl. 1959) (in deciding dividend equivalence in a reorganization the court must look to "all the facts and circumstances surrounding the distribution to appraise the consequences of the transaction"); Treas. Reg. § 1.302-2(b) ("[t]he question whether a distribution in redemption of stock of a shareholder is not essentially equivalent to a dividend under section 302(b)(1) depends upon the facts and circumstances of each case").

90. United States v. Fewell, 255 F.2d 496, 500-01 (5th Cir. 1958).

91. United States v. Carey, 289 F.2d 531 (8th Cir. 1961).

92. United States v. Davis, 397 U.S. 301, *reh'g denied*, 397 U.S. 1071 (1970); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962); *Carey*, 289 F.2d at 538; *Fewell*, 255 F.2d at 500.

93. Lewis v. Commissioner, 176 F.2d 646, 648 (1st Cir. 1949) (citing Darrell, *The Scope of* Commissioner v. Bedford's Estate, 24 TAXES 266, 272 (1946)).

94. *Idaho Power*, 161 F. Supp. at 810.

95. *See supra* note 67 and accompanying text.

reduction in control of the corporation, then a stock redemption more closely resembles a dividend.[96]

In *United States v. Davis*[97] the United States Supreme Court stated that "to qualify for preferred treatment under [section 302(b)(1)], . . . a redemption must result in a *meaningful* reduction of the shareholder's proportionate interest in the corporation."[98] In this case the Supreme Court looked at a redemption of preferred stock and refused to give the taxpayer capital gains treatment because the redemption did not reduce his proportionate interest in the corporation.[99] Under *Davis* when a corporation redeems stock from a sole shareholder, the redemption will be taxed as a dividend to the extent that there are earnings and profits.[100] Section 302(b)(1) will not, therefore, apply in these cases. But the *Davis* Court did not render section 302(b)(1) totally useless; it recognized that where a taxpayer experiences a meaningful reduction in his proportionate interest, he may utilize section 302(b)(1).[101] Therefore, if there is more than one shareholder in the corporation and if a corporate redemption reduces his interest in the corporation disproportionately, the shareholder may be protected by section 302(b)(1) if the reduction was meaningful.

The taxpayer in *Davis* retained full control of the corporation since he owned all of the voting stock.[102] Since he owned over 50% of the voting stock and did not experience a substantial reduction in the corporation, he also could not qualify for the "safe harbor" provision of section 302(b)(2).[103]

1. The Step Transaction Doctrine

The meaningful reduction test of *Davis* has been applied by the courts with different, sometimes conflicting, results.[104] Confusion was compounded when the courts sought to apply the test in corporate reorganizations. The problem arose as to *when* the test should be applied.[105]

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96. Commissioner v. Berenbaum, 369 F.2d 337, 341 (10th Cir. 1966).

97. 397 U.S. 301, *reh'g denied*, 397 U.S. 1071 (1970).

98. *Id.* at 313 (emphasis added).

99. *Id.* The taxpayer was the sole shareholder in this corporation after application of the section 318 family attribution rules. Since the corporation had earnings and profits in excess of the amount redeemed and since the taxpayer was the sole shareholder, the court held that any redemption would have the effect of a dividend distribution. *Id.*

100. *Id.* at 307.

101. *Id.* at 313.

102. *Id.*

103. This provision is commonly referred to as a "safe harbor" provision since preferred tax treatment is accorded when the tests of 302(b)(2)(C) are met.

104. *See* Morris v. United States, 441 F. Supp. 76 (N.D. Tex. 1977) (taxpayer with 50% of voting common stock redeemed his non-voting preferred stock and was held to have experienced a meaningful reduction since he no longer had the right to his 5% of par value of stock yearly dividend, which was payable even before corporate officers and management had received their salaries); Rickey v. United States, 427 F. Supp. 484 (W.D. La. 1976), *aff'd*, 592 F.2d 1251 (5th Cir. 1979) (applied the meaningful reduction test and decided that taxpayer was entitled to capital gains treatment since his voting stock ownership was reduced from 72% to 49%).

105. Shimberg v. United States, 577 F.2d. 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979) (holding that the test is applied before the reorganization); Wright v. United States, 482 F.2d 600 (8th Cir. 1973) (holding that the test is applied after the reorganization is complete).

One pre-*Davis* court held that, in determining tax consequences in corporate reorganizations, the entire transaction should be viewed as a unified whole.[106] Instead of looking at each step in the reorganization separately and defining the tax consequences on each step, the steps must be viewed as parts of an integrated transaction.[107] The step transaction doctrine recognizes that a transaction which requires a number of steps is realistically unified, the tax should be assessed viewing the transaction as a whole.[108] In determining whether boot has the effect of a dividend distribution, section 302 principles apply to the entire transaction.

2. Post-reorganization Application: *Wright v. United States*

In *Wright v. United States*,[109] the taxpayer owned controlling interest in three corporations: Danco Construction Co. (Danco), F & G Construction Co. (F & G), and World Wide, Inc. (World Wide).[110] The taxpayer's business associate owned shares in Danco and World Wide, but not in F & G.[111] The taxpayer and his associate wanted to merge World Wide and F & G with each retaining the same proportionate interest in the new corporation (to be named Omni Corporation) as they each owned in Danco.[112] A pure stock-for-stock exchange would have given the taxpayer 85% and his business associate 10% of Omni common stock. In order to keep the proportionate interest in Omni the same as in Danco,[113] the taxpayer accepted 61.7% of Omni stock and a $102,002 interest-bearing promissory note issued by Omni.[114] The taxpayer's associate paid $7,005.57 to Omni and received 27.8% of Omni stock.[115]

Since the promissory note was boot within the meaning of section 356(a)(1)(B), the court had to decide whether to characterize the note as gain coming from the exchange of property or as ordinary income if it had the effect of a dividend distribution. The Commissioner of Internal Revenue argued that to determine if the boot had the effect of a dividend or if it was a sale, the note should be viewed as a redemption of stock made *before* the reorganization.[116] A pre-reorganization treatment would render the promissory note as having been issued to the taxpayer by F & G.[117] Since under this interpretation the taxpayer's interests

106. King Enters. v. United States, 418 F.2d 511 (Ct. Cl. 1969). *See also* Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954) (in a stock redemption court looked at the whole transaction and determined that since overall effect was to extinguish taxpayer's interests in the corporation then the transaction was not equivalent to a dividend); Rev. Rul. 75-447, 1975-2 C.B. 113 (affirming *Zenz* approach of looking to overall transaction).

107. *King Enters.*, 418 F.2d at 516.

108. *Id.*

109. 482 F.2d 600 (8th Cir. 1973).

110. *Id.* at 602.

111. *Id.*

112. *Id.*

113. The taxpayer owned 71.5%, and his associate owned 27.9% of Danco. The remainder was owned by the taxpayer's attorney.

114. *Wright*, 482 F.2d at 603.

115. *Id.* The remaining 10.5% was owned by taxpayer's wife, mother, and attorney.

116. *Id.* at 606.

117. *Id.*

would only have been reduced from 99.16% to 95.43%, this would not constitute a substantially disproportionate distribution under section 302(b)(2)(C).

The court viewed the pre-reorganization analysis as artificial because it failed to recognize that a reorganization had taken place.[118] The court stated that "[t]he issuance of the note was part of an entire corporate reorganization based on the capital accounts of both F & G and World Wide."[119] The court further stated that "the note was issued by Omni in exchange for a portion of Omni stock that the taxpayer would have received if he had taken Omni stock entirely instead of receiving Omni stock and a note issued to him by Omni."[120] Applying a post-reorganization analysis, the court recharacterized the single reorganization into two transactions: (1) a reorganization in which "stock" replaced the boot actually received by the shareholder and (2) a redemption of the "stock" in exchange for the boot received.[121] The court then applied the redemption rules of section 302 to the hypothetical redemption.[122]

The *Wright* court decided that the 23.3% reduction was a meaningful reduction and, therefore, should be taxed at capital gains rates. Even though the taxpayer still owned over 50% of the voting stock, taking the transaction out of the section 302(b)(2) safe harbor provision, the court still found that the taxpayer was entitled to capital gains treatment since he experienced a meaningful reduction and, therefore, qualified for exchange treatment under section 302(b)(1).[123] The court viewed the transaction as more closely resembling a sale rather than a dividend because the taxpayer "relinquished valuable rights in the future business."[124] Specifically, the taxpayer after the reduction could no longer unilaterally make certain corporate decisions – decisions to amend the articles of incorporation, to merge or consolidate, or to liquidate – because under Arkansas law (the place of incorporation) a 2/3 vote would be required for such corporate action.[125]

3. Pre-reorganization Application: *Shimberg v. United States*

In *Shimberg v. United States*,[126] the taxpayer owned 66.8% of LaMonte-Shimberg Corporation (LSC).[127] LSC entered into a type A merger[128] with MGIC Investment Corp. (MGIC).[129] Pursuant to the merger agreement LSC stockholders received MGIC stock and cash. The taxpayer received 21,461 shares of MGIC

118. *Id.* at 607.
119. *Id.*
120. *Id.*
121. *Id.*
122. While this analysis is also artificial, it at least recognizes that a reorganization occurred.
123. *Wright*, 482 F.2d at 609.
124. *Id.* at 607.
125. *Id.* at 609.
126. 577 F.2d 283 (5th Cir. 1978), *cert. denied*, 439 U.S. 1115 (1979).
127. *Id.* at 284.
128. I.R.C. § 368(a)(1)(A) (1986).
129. *Shimberg*, 577 F.2d at 285.

stock plus $417,449 in exchange for his LSC stock.[130] The taxpayer characterized the boot as long-term capital gain, but the Commissioner determined that the boot had the effect of a dividend distribution and was taxable as ordinary income.[131] The taxpayer paid the deficiency assessed against him and brought a refund suit in district court.[132] The district court compared the taxpayer's prior interest in LSC (66.8%) with his present, post-reorganization interest in MGIC (less than 1%) to find that he had experienced a meaningful reduction and was therefore entitled to capital gains treatment.[133]

The Fifth Circuit reversed the district court's holding.[134] The circuit court was concerned that the district court's holding would result in capital gains treatment in all cases where a small corporation is merged into a large one.[135] The circuit court stated that "[a] contrary holding would render section 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations."[136]

To determine whether the boot had the effect of the distribution of a dividend, "dividend" must be defined. Section 316 of the Code defines dividend as "any distribution of property made by a corporation to its shareholders . . . out of its earnings and profits."[137] A reorganization is "tax free" only if it meets the continuity of proprietary interests in the continuing corporation test of Treasury Regulation 1.368-1(b). Reading section 356(a)(2) as requiring a pre-reorganization determination of whether the distribution was to be taxed as a dividend, the Fifth Circuit stated:

> If a pro rata distribution of profits from a continuing corporation is a dividend, and a corporate reorganization is a 'continuance of the proprietary interests in the continuing enterprise under modified corporate form,' it follows that the pro rata distribution of 'boot' to shareholders of one of the participating corporations must certainly have the 'effect of the distribution of a dividend' within the meaning of [section] 356(a)(2).[138]

Under the 356(a)(2) test the boot is treated as though it had been distributed in a redemption prior to the reorganization. The Fifth Circuit therefore found that if the distribution in *Shimberg* had been made prior to the merger it would have constructed a distribution of a dividend since the distribution was pro rata and outside exchange treatment of section 302(a) and since LSC had undistributed earnings

130. *Id.*

131. *Id.*

132. Both LSC and MGIC had undistributed earnings and profits exceeding the boot payment.

133. *Shimberg*, 577 F.2d at 286.

134. *Id.* at 287-88.

135. *Id.* at 288.

136. *Id.*

137. I.R.C. § 316 (1986).

138. *Shimberg*, 577 F.2d at 288 (citations omitted).

and profits in excess of the amount distributed.[139] The court was concerned that an anomalous result would ensue if the taxpayer was required to pay ordinary income rates upon receipt of a dividend distribution but would be entitled to a capital gains treatment upon receipt of a distribution made pursuant to a type A merger.[140] Reading the legislative history of the predecessor to section 356(a)(2) as supporting its rationale,[141] the court stated that a taxpayer should not be entitled to capital gains treatment simply because he received his share of the distribution after the merger instead of before.[142]

IV. Instant Case

Adopting the pre-reorganization test of the *Shimberg* court, the Commissioner of Internal Revenue argued in *Clark* that the $3,250,000 boot Clark received should be viewed as a redemption by Basin *prior* to the reorganization.[143] According to this view the boot would have had the effect of a dividend since Clark was the only Basin shareholder and any distribution would have been pro rata so that Clark's proportionate interest in Basin would have been unchanged.[144]

Clark argued that, instead of looking at the boot as a pre-reorganization redemption, the test should require "that one imagine a pure stock-for-stock exchange, followed immediately by a *post*-reorganization redemption of a portion of the taxpayer's shares . . . in an amount equal to the boot."[145] If this view prevailed, the boot would not have had the effect of the distribution of a dividend since Clark would have experienced a substantially disproportionate reduction of interest.[146]

The Court agreed with Clark's characterization of the boot as coming from a post-reorganization redemption of N.L. stock.[147] The Court stated that section 302 applied in determining whether the boot had the effect of a distribution of a dividend but noted that section 302 applied to stock redemptions of single corporations and not specifically to stock redemptions made pursuant to a reorganization between two corporations.[148] Because of this, section 302 does not deal with whether to treat the hypothetical redemption "as a pre-reorganization distribution coming from the acquired corporation or as a post-reorganization distribution coming from the acquiring corporation."[149] Because it recognized that the trans-

139. *Id.* at 289.

140. *Id.*

141. The legislative history was concerned with a deliberate creation of another corporation for the purpose of routing earnings and profits into a new corporation and giving boot in addition to stock in the new corporation. H.R. Rep. No. 179, 68th Cong., 1st Sess., 14-15 (1924) [1939-1 C.B. (part 2), 241, 252].

142. *Id.*

143. *Clark*, 109 S. Ct. at 1459.

144. *Id.* at 1459-60.

145. *Id.*

146. *Id.*

147. *Id.* at 1463.

148. *Id.* at 1461.

149. *Id.*

action was integrated the Court thought it made more sense to view the transaction as a post-reorganization redemption.[150]

In supporting its view that the post-reorganization rationale should apply, the court pointed to three ways that Congress indicated its approval of this rationale.[151] First, section 356(a)(2) says that if the *exchange* has the effect of a dividend distribution, it will be taxed as ordinary income.[152] This language indicates that Congress intended that the transaction be viewed as an integrated whole and not separated into parts with the tax consequences determined on each separate part.[153] Second, section 356 applies to property, non-taxable property under section 354 or section 355, as well as other property taxable and "received in the exchange." This language indicates that the entire transaction, not just the property which is not recognized for taxation, is to be viewed when determining whether capital gains applies.[154] Finally, the Court found that since "section 356 expressly limits the extent to which boot may be taxed to the amount of gain realized in the reorganization . . . Congress intended that boot not be treated in isolation from the overall reorganization."[155]

The Court stated that its finding is consistent with the step-transaction doctrine, which the government itself had adopted,[156] where interrelated steps in an integrated transaction were to be viewed together. Viewing the boot payment as part of the overall exchange "acknowledges that there would have been no cash payment absent the exchange."[157]

Once the Court decided to use the post-reorganization approach as propounded by *Wright,* it applied section 302 and concluded that Clark was protected by the safe harbor provisions of section 302(b)(2). The Court characterized the boot as N.L.'s redemption of 125,000 shares of its common stock. Had Clark accepted the pure stock-for-stock offer, he would have owned 425,000 shares of N.L. stock, giving him a 1.3% voting interest in N.L. Since the transaction was to be viewed as a post-reorganization redemption of N.L. stock, the distribution was substantially disproportionate to Clark under section 302(b)(2).[158] Therefore, Clark was correct in his assessment of the boot as a long-term capital gain.

Although acknowledging that the post-reorganization view was artificial because it "imagine[d] that the redemption occurred outside the confines of the actual reorganization,"[159] The Court also stated that this view should prevail over the pre- reorganization theory. The post-reorganization view at least "recognizes

150. *Id.* at 1462.
151. *Id.*
152. *Id.*
153. *Id.* (citing Rev. Rul. 75-447, 1975-2 C.B. 113).
154. *Id.*
155. *Id.*
156. *Id.*
157. *Id.* at 1463.
158. Clark's post-redemption percentage of voting stock was less than 80% of his pre-redemption percentage of voting stock. For an example application of the substantially disproportionate standard see *supra* note 66.
159. *Clark*, 109 S. Ct. at 1464.

that a reorganization has taken place, while the pre-reorganization approach recasts the transaction to the exclusion of the overall exchange."[160]

The Court further reasoned that in enacting section 356 Congress was concerned with reorganizations that were designed to " 'siphon-off' accumulated earnings and profits at a capital gains rate . . . ."[161] The Court stated:

> This purpose is not served by denying capital gains treatment in a case such as this in which the taxpayer entered into an arm's length transaction with a corporation in which he had no prior interest, exchanging his stock in the acquired corporation for less than a one percent interest in the acquiring corporation and a substantial cash boot.[162]

Justice White, the sole dissenter in *Clark,*[163] argued that since Clark was the only Basin shareholder, any payment to him would have the effect of the distribution of a dividend because a payment to him would be pro rata.[164] He also argued that Clark's retention of a proprietary interest in the continuing corporation was a further indication that the boot was equivalent to a dividend.[165] White's contention was that by trying to abolish the automatic dividend rule, the majority had imposed an automatic non-dividend rule which would apply even in pro rata distributions.[166]

V. Analysis

The *Clark* decision is important for a number of reasons. *Clark*'s resolution of the circuit split will facilitate uniform application of the tax laws. *Clark* also confirms that the section 302(b) tests are to be used in deciding whether boot in a corporate reorganization has the effect of a divided distribution. As the *Clark* Court itself acknowledged, the post-reorganization view is somewhat artificial; however, by adopting it the Court made the more logical choice, given the alternative. At first glance, it appears that *Clark* is of limited significance, given the repeal in the 1986 tax reform of section 1202, which allowed a 60% deduction of net capital gains from gross income. This analysis will examine *Clark's* significance before the 1986 tax reform and its continued importance even in light of section 1202's repeal.

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160. *Id.*
161. *Id.*
162. *Id.*
163. *Id.* at 1466.
164. *Id.* at 1467.
165. *Id.*
166. *Id.*

A. *Commissioner v. Clark*: *"Wrightly" Decided*

1. Confirmed *In Pari Materia* Application of Sections 302 and 356

Clark confirmed *in pari materia* application of section 302 and section 356, thus rejecting *Shimberg*'s refusal to apply section 302 to reorganization cases.[167] This approach is more rational given section 356's silence on when boot has the effect of a dividend. The Fifth Circuit approach in *Shimberg* would render section 356(a)(2) useless. Under the *Shimberg* approach, if earnings and profits existed in the acquired corporation's shareholders, the boot would automatically be determined to have the effect of a dividend. The *Shimberg* Court argued that section 356 would be otherwise useless in all situations where a large corporation acquired a smaller one because there would always be a reduction in interest where the stockholders of the small, acquired corporation are concerned.[168] However, the *Shimberg* Court failed to consider that had Congress intended that section 356 be given the *Shimberg* Court's interpretation, it would not have framed section 356(a)(2) as an exception to the general rule that property accompanying stock in a reorganization is recognized as gain.[169] The Supreme Court's acceptance of applying the section 302(b)(2) tests in determining whether boot has the effect of a dividend in reorganizations will aid future courts faced with this decision.

2. Resolved Post-reorganization vs. Pre-reorganization Conflict

The *Clark* Court's decision to view the boot as a hypothetical redemption after the reorganization had taken place is preferable to *Shimberg*'s pre-reorganization view. Under *Shimberg*, any pre-reorganization redemption would be a dividend to the extent that the acquired corporation had undistributed earnings and profits.

The *Shimberg* court's insistence on using the pre-reorganization test stems from its misunderstanding of the *Wright* post-reorganization test. The *Shimberg* court interpreted the test as requiring a comparison between the stockholder's interest in the acquired corporation with his post-reorganization interest in the acquiring corporation. For this reason the *Shimberg* court stated that in "minnow-whale" reorganizations the stockholders of the acquired corporation would always experience a meaningful reduction.[170] The test in *Wright*, however, was a comparison of the stockholder's interest in the acquiring corporation that he would have had if he had accepted only stock, with his interest in the acquiring corporation that he actually had after accepting stock and boot.[171]

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167. *Id.*

168. *Shimberg*, 577 F.2d at 288.

169. I.R.C. § 356(a)(2) (1986) states that "*[i]f* an exchange is described in paragraph (1) *but* has the effect of the distribution of a dividend . . . *then* there shall be treated as a dividend . . . such an amount . . . as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated . . . ." I.R.C. § 356(a)(2) (1986) (emphasis added).

170. *Shimberg*, 577 F.2d at 288.

171. *Wright*, 482 F.2d at 607.

The *Shimberg* court was particularly concerned that a taxpayer should not receive preferential tax treatment simply because he chose to receive his share of a distribution after the merger instead of before. The court cited the legislative history of section 356 in support.[172] The legislative history, however, is concerned with a deliberate creation of another corporation for the purpose of routing earnings and profits into a new corporation and giving boot as well as stock in the newly-created organization.[173] In a situation such as this, the stockholders of the old corporation retain the same interests in the newly-created corporation. This is far different from a situation in which a stockholder has experienced a substantial reduction in interest in the acquiring corporation.

As previously stated, the test of *Wright* is also artificial because it imagines a hypothetical redemption of stock by the acquiring corporation after the reorganization has occurred. However, as the Supreme Court recognized in *Clark*, at least this view acknowledges that the boot would not have been distributed without the reorganization. If the step-transaction doctrine is to survive, the post-reorganization analysis must prevail since it views the entire transaction as parts of an interrelated whole.

3. Provided Consistentcy with the Purpose of Section 356

The *Clark* Court's adoption of *Wright* over *Shimberg* is more consistent with the purpose of section 356. Section 356 was designed by Congress to prevent corporations from purposefully bailing out earnings and profits at capital gains rates.[174] When such a purposeful intent in siphoning-off earnings and profits is not present, however, section 356 should not operate to deny capital gains treatment. The method by which courts should determine whether a reorganization was entered into for the purpose of bailing-out earnings and profits is to scrutinize the post-reorganization situation of the stockholders. If the stockholder has retained relatively the same interests in the new corporation even after the boot distribution as he owned in the old corporation, then the distribution of boot looks more like a dividend and should be taxed as such. If, however, the stockholder's interests have been substantially reduced after the boot has been distributed, it is difficult to

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172. *Shimberg*, 577 F.2d at 289 n.16.

173. H.R. Rep. No. 179, 68th Cong., 1st Sess. 14-15 (1924) [1939-1 C.B. (part 2), 241, 252]. The House Report gives the following example:

> Corporation A has capital stock of $100,000, and earnings and profits accumulated since March 1, 1913, of $50,000. If it distributes the $50,000 as a dividend to its stockholders, the amount distributed will be taxed at the full surtax rates. On the other hand, corporation A may organize corporation B, to which it transfers all its assets, the consideration for the transfer being the insurance by B of all its stock and $50,000 in cash to the stockholders of corporation A in exchange for their stock in corporation A. Under the existing law, the $50,000 distributed with the stock of corporation B would be taxed, not as a dividend, but as a capital gain, subject only to the 12 1/2 per cent rate. The effect of such a distribution is obviously the same as if the corporation had declared out as a dividend its $50,000 earnings and profits. If dividends are to be subject to the full surtax rates, then such an amount so distributed should also be subject to the surtax rates and not to the 12 1/2 per cent rate on capital gain. Here again this provision prevents evasions.

Id.

174. *Id.*

view the reorganization as a deliberate attempt to receive a dividend by concealing earnings and profits in a capital exchange transaction in order to receive favorable tax treatment.

In *Shimberg*, if LSC had intended a bail out, it does not seem likely that it would have sought to accomplish this through a reorganization that left its stockholders with less than 1% voting interest in the surviving corporation. For this reason, *Wright* is more consistent with section 356, and the *Clark* Court was correct in adopting the *Wright* standard.

B. Clark's Importance After the 1986 Tax Reform

1. Remaining Statutory Distinction Between Capital Gains and Ordinary Income in the 1986 Tax Code

The 1986 Tax Reform Act saw the exclusion of section 1202 from the 1986 Internal Revenue Code. Section 1202 provided that individual taxpayers could deduct 60% of their net capital gain from gross income.[175] Although this specific provision was eliminated from the Code, the other Code provisions which distinguished between capital gains and ordinary income remained intact.

Given the condition of the United States budget deficit, one reason which has been advanced for the retention of the statutory distinction is that, Congress may increase the tax rate on ordinary income.[176] If it does, special provisions for capital gains may be reinstated.[177] In fact, congressional intention in retaining the statutory distinction between capital gain and ordinary income was "to facilitate reinstatement of a capital gains rate differential if there is a future tax rate increase."[178]

If Congress determined that retention of the distinction was important because of a likelihood that capital gains rates would be reinstated, *Clark*'s resolution of the boot taxation issue remains significant. Given the very real possibility that capital gains rates will be reinstated, *Clark* should not be dismissed simply because capital gains are currently taxed as ordinary income.

2. Offset of Capital Gain by Capital Losses

Section 1211 of the 1986 Code provides that capital losses may be fully allowed to the extent that there are capital gains.[179] This provision is important because capital losses are not fully deductible from ordinary income. Capital losses may be deductible from ordinary income only up to $3,000.[180] Allowing the taxpayer to deduct capital losses from capital gains is beneficial, even though the capital

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175. I.R.C. § 1202 (1984).

176. Faber, *Capital Gains vs. Dividends in Corporate Transactions: Is the Battle Still Worth Fighting?*, 64 TAXES 865, 873 (1986).

177. *Id. See also* Gardner & Stewart, *Capital Gains and Losses After the Tax Reform Act of 1986*, 65 TAXES 125, 129 (1987).

178. H.R. REP. No. 841, 99th Cong., 2d Sess., II-106 (1986).

179. I.R.C. § 1211(b) (1986).

180. Or $1,500 when a married individual files a separate return. I.R.C. § 1211(b)(2) (1986).

gains are taxed at ordinary income rates. For example: if X has capital gains of $100,000 and no capital losses, he must pay the same tax as if this were ordinary income on the entire $100,000. If, however, X had capital losses of $50,000, section 1211(b) allows him to deduct this loss from his $100,000 of capital gains. This would leave $50,000 of taxable income. If X had no capital gains, then he could only deduct $3,000 of his capital losses against his ordinary income.

The Code's allowance of capital loss deduction from capital gains makes the distinction between dividend and capital gains in boot distributions important. If a court finds that boot had the effect of a dividend, this would be ordinary income and only $3,000 of capital losses from other transactions can be deducted. Conversely, if the court finds boot to be capital gain, then capital losses from other transactions are fully deductible up to the amount of the boot. Obviously, this characterization of boot as capital gain results in less taxable income where the taxpayer has experienced capital losses in other transactions. Though the capital gain is taxed at the same rate as ordinary income, there is less to be taxed.

Because capital gains may be offset by capital losses, *Clark*'s resolution of the issue of when to apply the section 302 standard in corporate reorganizations is important.

VI. Conclusion

The *Clark* decision confirms the validity of using section 302(b) tests when determining how to tax boot in a corporate reorganization. *Clark* resolves the conflict among the courts as to the method to be used for taxing boot. *Clark* clears up the confusion and, therefore, aids more uniform application of the tax laws in reorganization cases involving payment of boot. Even with the repeal of section 1202, *Clark* remains significant, since capital gains may be offset by capital losses. Furthermore, future legislation may see the reinstatement of a capital gains deduction.

Lisa Thompson Sykes