University of Pennsylvania

Law Review

FOUNDED 1852

Formerly
American Law Register

VOLUME 124

DECEMBER 1975

NUMBER 2

PUBLIC STOCK, PRIVATE STOCK: A MODEL FOR THE CORPORATE INCOME TAX

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I. INTRODUCTION

A. *The Basic Premise*

Should public stock be treated differently from private stock for federal corporate income tax purposes? The idea is not entirely new. At least two writers have thought that public stock might usefully be distinguished from private stock for certain limited tax purposes.¹ This Article, however, is broader in scope than prior scholarship. It examines the factual basis and the legal justification for a consistent, complete distinction in the corporate income tax treatment of public stock and private stock. This distinction between public stock and private stock rests upon a single basic premise: Public stock is separate property, and private stock is not separate property.

Public stock is property that is separate and apart from the underlying corporate assets. Its voting rights are largely meaningless; its power to control the corporation and the underlying assets is virtually nonexistent. Its value derives primarily from a separate public stock market which is only indirectly supported by the values of the underlying corporate assets. Private stock, on the other hand, is not "separate property" because its value is tied directly to the values of the underlying corporate assets.² Its voting rights are meaningful; its power to control is strong. No established market exists in which private stock can readily be sold. Part II of this Article explores this factual distinction.

The relation of the basic premise to established legal principles is a bit more complex. "Income," from the federal income tax standpoint, requires two elements: a "receipt" of "value." The term "property" embodies both elements; "property" can be thought of as anything that has value and that is capable of being received in the sense of being owned legally. Part III examines the legal principles relating to why public stock should be

¹ Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254, 281-85 (1957); Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623 (1967). Slawson proposed that the annual appreciation in publicly held stock be taxed each year to the stockholders whether or not corresponding dividends were paid out. He limited his proposal to publicly held stock because published market quotations make its value readily determinable without an actual disposition. Hellerstein advocated doing away with non-recognition of gain or loss in reorganization exchanges, but he, too, limited his proposal to publicly traded stock primarily for practical reasons.

² The "underlying corporate assets" means the *net* assets (assets minus liabilities), but should be taken to include the going-concern value of the business, the "goodwill."

considered "separate property," and why private stock should not.

Part IV presents a transactional analysis of public stock as "separate property" and private stock as not "separate property." In general terms, "separate" represents a refinement of the element of a "receipt." It refers to the requirement that a receipt, to be recognized for tax purposes, be a meaningful one. This, in turn, depends upon whether the receipt is significantly different in form from what was given up in exchange. If two properties of "like kind" or two properties "similar or related in service or use" are exchanged, Congress has seen fit in certain cases not to recognize the exchange for tax purposes.³ The result is to put off taxing the receipt until a later, more meaningful exchange occurs.

Recognizing public stock as property that is separate from the underlying corporate assets means that there can be a meaningful exchange between the two whereas there cannot with private stock. Lack of a meaningful exchange is the main reason underlying the present non-recognition provisions governing certain transactions involving stock.⁴ The transactional analysis in Part IV examines this "separate property" aspect and applies Part III's conclusions to each of the six basic types of stock transactions: incorporations, dividends, liquidations, redemptions, sales, and reorganizations.⁵ Finally, Part V consolidates the conclusions from the foregoing sections in the form of model corporate income tax provisions.

Even if the model were otherwise acceptable, there would be myriad economic, political, and even psychological considerations to be weighed for and against a complete scrapping of the present system in favor of a new one.⁶ I have not even tried to

³ INT. REV. CODE OF 1954, §§ 1031, 1033.

⁴ INT. REV. CODE OF 1954, §§ 305(a) (stock dividends), 311 (distributions of appreciated property), 333 (one-month liquidations), 336 (liquidation distributions), 351 (incorporation transfers), 354 & 361 (reorganization exchanges).

⁵ The current statutory provisions comprise Subchapter C of the Internal Revenue Code of 1954, §§ 300-95, except for stock issuances and sales, §§ 1001-16, 1032, 1091. These, of course, are not the only types of transactions in which a corporation can engage. Its day-to-day business transactions generally are governed by the same rules that apply to unincorporated taxpayers. These six areas, though, are the basic ones that involve stock transactions.

⁶ E.g., R. BLOUGH, *THE FEDERAL TAXING PROCESS* (1952); J. GALBRAITH, *ECONOMICS AND THE PUBLIC PURPOSE* (1974); JOINT COMM. ON THE ECONOMIC REPORT, 84TH CONG., 1ST SESS., *FEDERAL TAX POLICY FOR ECONOMIC GROWTH AND STABILITY* 497-595 (Comm. Print 1955). See also Surrey, *The Congress and the Tax Lobbyist—How Special Tax Provisions Get Enacted*, 70 HARV. L. REV. 1145 (1957).

catalog these considerations, much less to integrate them into the analysis that follows. The purpose of this Article is simply to suggest a new theoretical corporate tax model—one which reflects modern corporation reality more accurately than does the present system—and then to put some flesh on its bones.

This Article does not question the basic assumption that a separate corporate income tax is a useful tax which ought to be retained,⁷ regardless of who ultimately bears the burden of that tax.⁸ Accordingly, consistent with that basic assumption, events that take place solely at the corporate level ought to be taxed there and not at the stockholder level. This is true whether public stock or private stock is involved. For public stock, the assumption is bolstered by the fact that events at the corporate level usually have no more than an indirect or peripheral effect on the stock. For private stock, however, the rationale for taxing at the corporate level cannot be couched in terms of the separateness of the corporation from its stock because, as we shall see, such separateness does not exist. Instead, the selection of a private corporation rather than an unincorporated form of doing business must be seen, from the tax standpoint, as a decision by the private stockholder to substitute (1) present corporate tax rates on the corporate taxable income together with future individual tax rates on dividends, as the earnings are taken out of the corporation, for (2) present individual tax rates on all of the unincorporated taxable income whether or not taken out of the business.

B. *The Present Statute*

The Internal Revenue Code has never reflected a decision to distinguish consistently between public and private stock. The corporate tax provisions are a mixed bag. Some treat both kinds of stock as separate property; others treat both as indistinguishable from the underlying corporate assets. Thus, when stock is

⁷ For a discussion of whether the corporate income tax ought to be integrated with the personal income tax, see J. PECHMAN, *FEDERAL TAX POLICY* 140-47 (1971); McLure, *Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals*, 88 HARV. L. REV. 532 (1975).

⁸ For discussions of the incidence of the corporate income tax, see R. GOODE, *THE CORPORATION INCOME TAX* (1951); M. KRZYZANIAK & R. MUSGRAVE, *THE SHIFTING OF THE CORPORATE INCOME TAX* (1963); E. SELIGMAN, *THE SHIFTING AND INCIDENCE OF TAXATION* (1975); Ratchford & Han, *The Burden of the Corporate Income Tax*, 10 NAT'L TAX J. 310 (1957); Schlesinger, *Corporate Income Tax Shifting and Fiscal Policy*, 13 NAT'L TAX J. 17 (1960).

sold outside the corporation by one stockholder to another stockholder, it usually is considered a separate capital asset regardless of the various types of underlying corporate properties.⁹ Capital gain or loss also normally results to a stockholder when the corporation redeems his stock or liquidates.¹⁰

On the other hand, an original issuance of stock, or a reorganization in the form of a merger of two corporations, a purchase of controlling stock, or a purchase of substantially all of the assets of one corporation in exchange for voting stock of another corporation, is treated as an inconsequential change in form and tax free.¹¹ The stock received is not treated as property that is separate from the assets or other stock exchanged for it. In tax terminology, no meaningful "realization" has taken place.¹²

Between these two kinds of treatment is the ordinary income treatment of dividends.¹³ Under the present statute, dividends received are not to be thought of as proceeds from the "sale" or "redemption" or "liquidation" of part of the value of the stock. If they were, the resulting tax should logically be at capital gains rates. Neither are they to be thought of as mere inconsequential shiftings of earnings from one pocket of the stockholder (his corporate pocket) to another (his unincorporated pocket), for then the receipt of a dividend should be deemed an inconsequential change in form and tax free. Dividends usually are thought of as being paid in return for the *use* of the stockholder's investment. From the stockholder's standpoint, dividends are thus ordinary income like rents, royalties, or interest received. Still, the corporation may not treat the payment of those same dividends as deductible expenses, as it can in the case of rent, royalty or interest expenses.¹⁴ From the corporation's standpoint, the stockholder presumably is merely drawing down what he already owns.

Two sections of the present Code specifically define "property," one as excluding stock and the other as including stock.

⁹ INT. REV. CODE OF 1954, § 1221.

¹⁰ INT. REV. CODE OF 1954, §§ 302, 331.

¹¹ INT. REV. CODE OF 1954, §§ 351, 1032 (original issuances); *id.* §§ 354, 368, 1032 (reorganizations).

¹² INT. REV. CODE OF 1954, §§ 1001, 1002. These sections provide, respectively, that gain or loss shall be "realized" (deemed to be received) and "recognized" (included in gross income) when property is sold or otherwise disposed of.

¹³ INT. REV. CODE OF 1954, §§ 301, 305, 306, 316, 317.

¹⁴ INT. REV. CODE OF 1954, §§ 162, 163.

Section 317's definition of "property" expressly excludes stock when it is used to pay a stock dividend or to redeem other stock outstanding. On the other hand, section 305(b) expressly includes stock as "property" when used for certain types of stock dividends.

These provisions, which make up the core of the corporate tax, vary the treatment of stock from one corporate event to another. They do not vary the treatment, however, as between public stock and private stock. Both public and private stock are treated as separate property for some purposes, and both are not for other purposes, regardless of the true facts.

Some peripheral provisions in the present statute treat private stock differently from public stock. These provisions, however, are based on practical, administrative considerations rather than on the principle that public stock is separate property although private stock is not. The Subchapter S provisions,¹⁵ for example, permit the stockholders of a corporation with ten or fewer individual stockholders and only one class of stock¹⁶ to elect not to pay the corporate income tax in return for current individual taxation of all of the corporate earnings, whether or not currently distributed as dividends. These Subchapter S provisions thus create a distinction between some private corporations and other corporations. Still, the requirements of ten-or-fewer-individual-stockholders and only-one-class-of-stock are not indicative of a congressional desire to recognize a distinction in principle between public stock and private stock; these requirements were inserted solely to keep Subchapter S corporations to a manageable size so that the Subchapter S provisions could be easily administered.¹⁷

In addition, a number of penalty tax provisions are more applicable to private corporations than to public corporations. These include the personal holding company provisions (which apply only if fifty percent of the stock is owned "by or for not more than 5 individuals"),¹⁸ the collapsible corporation provisions (which are based upon stockholder intent to use the corporate

¹⁵ INT. REV. CODE OF 1954, §§ 1371-78.

¹⁶ INT. REV. CODE OF 1954, § 1371(a).

¹⁷ See S. REP. NO. 1622, 83d Cong., 2d Sess. 452-55 (1954). The Fifth and Seventh Circuits have relied on this legislative history to conclude that certain purported debt instruments were not a second class of stock even though they failed as true debt. *Portage Plastics Co. v. United States*, 486 F.2d 632 (7th Cir. 1973); *Shores Realty Co. v. United States*, 468 F.2d 572 (5th Cir. 1972).

¹⁸ INT. REV. CODE OF 1954, § 542(a)(2).

form only temporarily to convert ordinary income into capital gain upon a stock sale or liquidation),¹⁹ the accumulated earnings tax provisions (which include a requirement that the corporate form was "formed or availed of for the purpose of avoiding the income tax with respect to its stockholders"),²⁰ and various self-dealing restrictions designed to prevent abuses of the power to control a corporation by causing it to engage in certain transactions for the personal benefit of the controlling stockholders.²¹ These penalty provisions were not predicated on the basic difference between public and private stock. They were, instead, piecemeal responses to abuses that arose because private stockholders are often in a position to use their control of the corporation to produce extravagant tax benefits.²² Yet these provisions contain a lesson. As we shall see, many of the loopholes that these provisions were designed to plug were created or enhanced by the failure of the Code's core provisions to reflect the basic difference between private stock and public stock.

II. PUBLIC STOCK VERSUS PRIVATE STOCK: A FACTUAL ANALYSIS

To get a better picture of the basic difference between public and private stock, we shall begin with two contrasting examples. Consider first a typical taxpayer who owns 100 shares of stock in a corporation consisting of his corner grocery store business. He owns, let us assume, all of the outstanding stock. He controls the board of directors, makes all decisions pertaining to the business, and is the sole employee of the corporation. No separate market exists for his stock. The value of his stock is tied directly to the value of the corporate assets; if this taxpayer wished to sell his stock, a potential buyer seeking to value the stock would go immediately behind the stock to the fair market value of the assets (including goodwill). The buyer would be interested in the earnings potential of these assets to the corporation as well as the price each would bring if sold separately. There would be no quick way to ascertain the value of these

¹⁹ INT. REV. CODE OF 1954, § 341(b)(1).

²⁰ INT. REV. CODE OF 1954, § 532(a).

²¹ INT. REV. CODE OF 1954, §§ 267, 269, 482, 1239.

²² See H. R. REP. NO. 894, 83d Cong., 1st Sess. 3-4 (1953) (§ 267); H. R. REP. NO. 586, 82d Cong., 1st Sess. 72-77 (1951) (§ 1239); H. R. REP. NO. 871, 78th Cong., 1st Sess. 24 (1943) (§ 269); H. R. REP. NO. 350, 67th Cong., 1st Sess. (1921) (§ 482).

assets; expert opinions would be costly and probably would vary considerably from one another.²³

A second typical taxpayer, let us assume, owns 100 shares of the common stock of a large public corporation, a General Motors or I.B.M., with thousands of stockholders. These shares, we will assume, represent 1/10,000th of the total outstanding stock of the company. This taxpayer is not a director, officer, or other employee and makes no corporate decisions. Although his shares have voting rights, these rights would be meaningful only upon the happening of an extraordinary event such as a major scandal in the corporate management.²⁴ Barring such an event, the top corporate officers and the directors invariably present matters that require stockholder votes to the stockholders in the form of single alternatives which permit only "yes" or "no" votes. Each such proposal is accompanied by the management's recommendation as to which way to vote. For as long as anyone can remember, the corporate management has never lost a stockholder vote.

The market value of this public stock is affected indirectly by what the corporation does and how well it does. It is also affected significantly, however, by the value of competing investments and by countless national and international economic and political events. Purchasers of the stock are not the same persons as those who would be interested in purchasing a portion of the corporate assets directly. The stock can be bought or sold on the New York Stock Exchange in a matter of minutes. The cost of buying and selling the stock is low, and there is no charge for obtaining up-to-date quotations of its price.

The stockholder of the grocery store corporation has complete control over the declaration and payment of dividends and

²³ E.g., *Garstin v. United States*, 352 F.2d 537 (Ct. Cl. 1965); *Hinkel v. Motter*, 39 F.2d 159 (D. Kan. 1930). Even the best appraisers have difficulty at times agreeing on the value of a piece of property. E.g., *Keystone Wood Products Co.*, 19 B.T.A. 1116 (1930), *aff'd*, 66 F.2d 258 (2d Cir. 1933).

²⁴ For a short time in the early 1970's some rather sporadic attempts were made to cause public corporations to be responsive to demands of their stockholders in areas of general public interest such as ecology or the needs of minority groups. See, e.g., Schulman, *Shareholder Cause Proposals: A Technique to Catch the Conscience of the Corporation*, 40 GEO. WASH. L. REV. 1 (1971); Vagts, *Reforming the "Modern" Corporation: Perspectives from the German* (pts. I & II), 27 *QUIS CUSTODIET?* 62, 121 (1970). More recently, the tide has seemed to turn away from such attempts. See, e.g., Burck, *The Hazards of "Corporate Responsibility"*, 87 *FORTUNE* 114 (June 1973); *Symposium—The Greening of the Board Room: Reflections on Corporate Responsibility*, 10 *COLUM. J. LAW & SOCIAL PROB.* 15 (1973).

other distributions, including the redemption of his shares and the liquidation of his corporation. He can move assets in and out of his corporation at will. He is even closer to the corporate assets than are the corporation's creditors, who must await fixed payment dates for their principal and interest.

By contrast, the stockholder of the public corporation is even further removed from the corporate assets than are the corporate creditors. The public stockholder has no right or power to demand payment of anything. Payment of a dividend on his shares, for example, is almost entirely within the control of the corporate officers and directors.²⁵ They, in turn, are at best indirectly responsive to market pressures. Redemption of his shares is also within the control of the officers and directors who may deal with him or not as they see fit. Barring a corporate or general economic catastrophe, liquidation is virtually unheard of.

In short, the private stock of the grocery store corporation is not really separate property at all, while the public stock is property that exists separate and apart from the issuing corporation's assets and earnings. The stockholder of the grocery store corporation might be thought of as having stepped "inside" the corporate shell with his grocery store assets. He has never relinquished personal ownership of those assets except in the barest legal sense. The public stockholder, by contrast, has permanently sold his share of the corporate assets and has bought his stock either from the corporation or from a former stockholder. He remains, for many purposes, "outside" the corporation.

These two examples state the polar extremes, but the same points can be made, to a greater or lesser extent, about the stock of any corporation. Stock like that of the corner grocery store represents direct, effective ownership and control of the corporate assets; its value is tied directly to the value of those assets. Stock like that of the public corporation represents neither ownership of the corporate assets (legally or even beneficially) nor control over their use; it derives its value from a separate stock market.

Private stock consists of certain private legal rights which we will call its "private characteristics." These are set forth in the applicable state corporation law, as interpreted by various judicial and administrative decisions, and in the corporation's articles

²⁵ See, e.g., *Moscowitz v. Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (Sup. Ct. 1963).

of incorporation and by-laws. These private characteristics are comprised of legal rights to receive future distributions of the corporate assets and, in the meantime, to exercise some degree of control over those assets.²⁶ Unless otherwise restricted, private stock may be sold if a buyer can be found. Private stock, economically, is a marketable receivable coupled with control.

Public stock includes these same "private characteristics," although they may be of much less value than if the stock were private stock. In this sense, we might say that within each share of public stock is a share of private stock. In addition, public stock possesses certain "public characteristics." The primary public characteristic is the existence of a separate market which gives the stock a value separate and apart from the value of the underlying corporate assets. Secondary characteristics include a lack of control over the corporation and its assets and lack of a direct connection between the corporate risks and benefits and the risks and benefits inherent in the public stock. These secondary characteristics work to reduce the value that the stock takes from the underlying corporate assets.

A. *Private Characteristics*

As can be seen from the foregoing examples, private stock consists of floating rights to receive whatever corporate assets would remain at any given time after first satisfying the corporate creditors. These rights to receive the net assets, of course, are not as fixed and definite as are the rights of the typical promissory note. They include no set payment dates and no fixed dollar amounts. Still, however contingent and variable the rights to receive the corporate assets may be, they do exist legally. At times, these rights are virtually impossible to distinguish from those of corporate securities or other true debt.²⁷ Often their value increases when the stockholder, either by himself or as a member of a small close-knit group of stockholders, possesses control of the corporation and its assets; such a controlling

²⁶ See, e.g., DEL. CODE ANN. tit. 8, §§ 151, 202, 211-30 (1974). In 1953 Delaware also adopted an interesting set of provisions, *id.* §§ 341-56, applicable only to "close corporations" (limited to not more than 30 stockholders) which permits the direct operation of the corporation by the stockholders and the division of profits in a fashion similar to partnerships.

²⁷ For an exhaustive review of the many cases and rulings on this problem, Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

private stockholder thereby possesses the power to exercise his rights to receive the corporate assets at will.

In a broad sense, any type of property is a "receivable" in that it has value that may be exchanged for other valuable property or services. Mere exchange value, however, is no substitute for the legal rights to receive which comprise the chief characteristics of a receivable in the legal sense. Tangible property, and many types of intangible property, thus are not receivables in a legal sense. The owner possesses no legal right to force an exchange for other property or services. The value of such property as a medium of exchange rests only in the property's continued desirability by others. Even cash is not a receivable.²⁸ Legally, the holder of cash cannot force anyone else to sell him other property or services in exchange for the cash. If he has entered into a contract, of course, then he may have such rights; in that case, however, the contract rights themselves constitute receivables, and, by combining these receivables with a payment of cash (if this is what the contract calls for), other property or services may be demanded.

Although legally, stock is not thought of as a receivable,²⁹ private stock is not much different economically from a demand note. The economic status of private stock as a receivable, moreover, is reinforced by the direct tie between its value and the values of the underlying corporate assets.³⁰ To the extent that control exists, the direct tie to the corporate assets is further established.³¹

²⁸ Paper bills technically are federal notes, of course, but that aspect is overshadowed completely by their acceptance as a medium of exchange.

²⁹ See, e.g., *Commissioner v. Boca Ceiga Dev. Co.*, 66 F.2d 1004 (3d Cir. 1933). See also text accompanying notes 40-58 *infra*.

³⁰ Guidelines for valuing closely held securities are set forth in Rev. Rul. 59-60, 1959-1 CUM. BULL. 237. See also Butala, *Valuation of Securities of Closely-Held Corporations*, 14 W. RES. L. REV. 193 (1963); Kascle, *Valuation of Closely-Held Corporations*, 43 TAXES 454 (1965).

³¹ Private stock in the hands of a minority shareholder arguably does not even rise to the level of a "receivable" in the sense that I have been using that term. At most, it is a receivable with an uncertain payment date because, by definition, the minority shareholder cannot unilaterally recover his pro-rata share of the underlying corporate assets. Such minority private stock might better be termed a "ticket" or "claim check" than a receivable. In its lack of control, minority private stock resembles public stock. It is here, however, that the resemblance ceases. The existence of a public market as an alternate source of valuation for public stock renders it highly liquid property that exists separate from the corporate assets. The absence of such a market for minority stock renders it the clearest example of stock that is not separate property. A control block of private stock, although economically a receivable, should not be currently taxable under the tests presently applied in the taxation of other receivables. See text accompanying notes 54-105 *infra*.

B. *Public Characteristics*

Even if, economically, stock would be a receivable, it may lose its character as such if it also possesses strong public characteristics. This is the case with public stock. In addition to possessing the same legal rights to receive the underlying corporate assets as does private stock, public stock possesses three public characteristics which distinguish it from private stock. The primary public characteristic is the existence of a separate market, usually in the form of an established stock exchange in which the public shares are readily tradable. The over-the-counter market may serve the same function.

A secondary public characteristic of public stock is the holder's typical lack of actual control over the corporation and its assets. This decreases the value of the private characteristics and thus, indirectly, increases the relative importance of the separate stock market. Another secondary public characteristic, the absence of a direct correlation between the risks and benefits accruing to the corporate assets and those accruing to the public stock, also tends to decrease the value of the private characteristics and to increase the relative value of the separate stock market. On balance, because the public characteristics of public stock are significantly more important than its private characteristics (by definition), public stock should be considered to be property that is not a receivable.

1. The Nature of a Public Stock Market

The recognized public stock markets are populated with buyers and sellers whose identity, numbers, objectives, and knowledge are vastly different from the buyers and sellers who would be interested in direct trading of the corporate assets. Theorists in corporate finance, however, contend that the value of any stock is determined strictly by the stockholder's rights to receive dividends, and, ultimately, to receive the remaining corporate assets upon liquidation.³² It would thus seem that the

³² "Thus, cash dividends are all that stockholders as a whole receive from their investment; they are all the company pays out. Consequently, the foundation for the valuation of common stocks must be dividends." J. VAN HORNE, *FINANCIAL MANAGEMENT AND POLICY* 21 (3d ed. 1974). "Therefore, if the average investor expects American Rubber to pay a \$2 dividend and to experience a 4 percent stock price appreciation from the reinvestment of retained earnings, and if he is to receive an 8 per cent return on his investment, then the initial investment—the current price—must be \$50." J. WESTON & E. BRIGHAM, *MANAGERIAL FINANCE* 292 (4th ed. 1972).

value of even public stock is directly tied to (1) the value of corporate assets (including goodwill) and (2) the dividend policy of the corporation. The relative weight to be accorded these two factors depends primarily on whether the investor desires growth in the value of his investment or currently distributed income.³³

Upon closer inspection, though, this equation between asset and stock values holds true only if *all assets* are included—not only the assets listed on the books, but also the goodwill and all other tangible and intangible factors not listed on the books which contribute to the value of the corporation's stock on the stock market.³⁴ These assets and factors, moreover, must be valued in the same way as the stock is valued, by the same people who are valuing the stock. The theorist's equation between assets and stock values, therefore, is nothing more than a tautology. Public stock values equal asset values only if one starts with the premise that asset values are first to be valued by reference to public stock values.

Instead, what investors really do is to try to outguess one another regarding the projected earning power of the assets.³⁵ Their strategy does not consist of simply determining the fair market values of the assets and the corporate policy for asset

³³ See VAN HORNE, *supra* note 32, at 14-31. Some theorists have isolated leverage obtained through debt financing rates as a third variable. Others include it in asset values. The well known Modigliani and Miller thesis, that financing makes no difference at all to stock values, assumes perfect substitution of financing alternatives and risk adjustment (called "arbitrage"). Miller & Modigliani, *Some Estimates of the Cost of Capital to the Electric Utility Industry, 1954-57*, 56 AM. ECON. REV. 333 (1966); Modigliani & Miller, *Corporate Income Taxes and the Cost of Capital: A Correction*, 53 AM. ECON. REV. 433 (1963); Modigliani & Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). For this reason, it is now largely discounted. See, e.g., Gordon, *Some Estimates of the Cost of Capital to the Electric Utility Industry, 1954-57: Comment*, 57 AM. ECON. REV. 1267 (1967).

³⁴ See *San Francisco Nat'l Bank v. Dodge*, 197 U.S. 70 (1905); *Adams Express Co. v. Ohio State Auditor*, 166 U.S. 185 (1897).

³⁵ Susan T. Freshman, 33 B.T.A. 394, 403 (1935) (stock exchange value was accepted even though experts testified that it was more than twice asset value due to an "hysterical state of mind on the part of the speculative public . . ."). See 1 A. DEWING, 1 THE FINANCIAL POLICY OF CORPORATIONS, 388 (5th ed. 1953) ("But the investor does not buy a business; he buys only a share of a business. It is, therefore, by no means conclusive that the price at which the investor values the common stock of an industrial enterprise, as compared with its earning capacity, throws light on the value of the enterprise."); B. GRAHAM & D. DODD, SECURITY ANALYSIS 531 (1940) ("The prices of common stocks are not carefully thought out computations but the resultants of a welter of human reactions."); *id.* 574-75: "It is an almost unbelievable fact that Wall Street never asks 'How much is the business selling for?' yet this should be the first question in considering a stock purchase. . . . This elementary and indispensable approach has been practically abandoned by those who purchase stocks."

distributions and then making a judgment as to what relative weight these assets should be accorded in the value of the stock. Their strategy does not even end with their personal valuation and inclusion of all other tangible and intangible factors. A significant part of investment strategy consists of predicting how other investors will value the stock, and whether the other investors will bid the stock price up or down in the future. All investors play the same game, and attempt to outguess their fellow investors. As the market expands, the game becomes more and more circular with the result that stock values move farther and farther away from asset values. Paraphrasing Justice Holmes, "the value of public stock consists of what the investors who make up the public stock market are likely to say it is."³⁶ The value that the market ultimately places on public stock depends to a great extent on factors that are not directly related to the underlying corporate assets—for example, the attractiveness of competing investments, the extent to which the particular industry is regulated and taxed, the existence of short interests, and the prevalence of odd-lot trading in the stock.

2. The Control Factor

A single stockholder rarely possesses enough shares to constitute legal control of a public corporation. For most purposes, this is over fifty percent of the total; for some purposes, two-thirds is required. Less rare are situations of de facto control in which one stockholder or a close-knit group owns, say, five percent of the total outstanding shares, representing practical control so long as a scandal or a disaster is avoided (such as would cause a large drop in the market price for the shares). Even so, the incumbent directors and officers, who easily perpetuate their own tenure and select their own replacements, control most public corporations. They do so by the sheer momentum of their own incumbency and by their control of the proxy machinery, rather than through stock ownership.³⁷

Shares of stock that do not carry effective control over the corporation and its assets are obviously not as directly tied to the asset values as comparable shares with control. The potential

³⁶ Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 461 (1897). "The prophecies of what the courts will do in fact, and nothing more pretentious, are what I mean by the law." *Id.*

³⁷ See, e.g., Eisenberg, *Megasubsidiaries: The Effect of Corporate Structure on Corporate Control*, 84 HARV. L. REV. 1577 (1971).

investor will attribute less of the underlying asset value to shares without control than to shares with control because the benefits to him from the underlying asset values are less certain. How much less depends upon what he can substitute for lack of control. If he has very high regard for the incumbent corporate management and does not foresee any situations in which he would exercise control to overrule the management, he might discount the asset values only slightly.

This is unusual. More common is a difference of twenty-five percent or more between the values of controlling and non-controlling shares.³⁸ As asset values are discounted for lack of control, the investor must look elsewhere for value. The relative importance of factors other than the asset values increases. If he can, if the shares are public stock, the investor is most likely to turn to the stock market.

3. Risks and Benefits

To an extent, the risks and the benefits of stock are opposite sides of the same coin. A stock's value, like the value of any asset, is comprised of the benefits which, it is forecast, will be derived directly or indirectly from that stock, tempered always by the risks of being wrong in that forecast. The key to tracing the risks and benefits of public stock to those of the underlying corporate assets is in the phrase "directly or indirectly." If the asset values actually will flow directly to the stockholders, for example, in the form of periodic, substantial dividends which can be counted on from one year to the next because of past corporate practices and a low level of corporate risk, the stock will draw direct value from that expectancy. There will be less need to look to the stock market for value.

The fact is, though, that most public companies pay out only a small portion of their annual earnings as dividends. The remainder is retained and reinvested in new corporate assets which only indirectly affect stock value.³⁹ As with control, the less direct the benefits, the less valuable the expectancy, and, therefore, the less valuable the private aspect of the stock. The stockholder again must turn to the public stock market for value.

³⁸ See Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares*, 122 U. PA. L. REV. 934 (1974).

³⁹ A comparison of the 1974 average dividend (\$37.72/share) with the 1974 average earnings (\$99.04/share) for the Dow Jones industrials, for example, shows that only 38% of the earnings were paid out as dividends. See 1 MOODY'S INVESTORS SERVICE, MOODY'S INDUSTRIAL MANUAL a67 (1975).

On the risk side, the same is true. Even if a corporation has had a policy in the past of paying out all earnings currently as dividends, if there is grave doubt that there will be any future earnings, the stockholder will either reduce the value or, if he can, look for alternative value to the stock market.

Risks and benefits, of course, are also characteristics of the stock market. High risk that the stock market will decrease or low expectation of a benefit from an increase in the stock market value would serve to drive an investor back to more direct reliance upon the underlying corporate asset values. Still, there is safety in numbers: the larger the number of stockholders buying and selling in the market, the more liquid the stock and the lower the risk borne by each individual stockholder. The more public the market, the more people there are to spread the risk.

III. STOCK AS "PROPERTY": AN ANALYSIS OF FAIR MARKET VALUE

We have seen that private stock, at most, has the characteristics of a receivable and that public stock does not because its public characteristics predominate.⁴⁰ We shall now consider the tax significance of these characteristics: Should a receipt of stock be considered a receipt of fair market value? If so, then depending upon the transaction involved, a receipt of the stock could be taxable. If not, a receipt of the stock should never be taxable.

A. *Fair Market Value: The General Rules*

The two elements basic to any item of income are a "receipt" of "value." "Value" means "fair market value."⁴¹ The prevailing rule of law regarding stock is clear: A receipt of stock, just like a receipt of most other property, is considered a receipt of fair market value.⁴² Of course, the fair market value might be zero because, for example, the corporation is hopelessly insolvent. It is very difficult, however, to argue that stock has no value if the taxpayer has recently exchanged valuable property or services for it. The Tax Court, in a 1944 opinion, rejected a taxpayer's argument that he had received stock of no value in return for his services. The court noted that the stock issuance would then have been "an empty gesture . . . a mockery."⁴³

⁴⁰ See note 31 *supra*.

⁴¹ INT. REV. CODE OF 1954, § 1001(b).

⁴² *E.g.*, C.A. Tilt, 14 B.T.A. 437 (1928).

⁴³ Estate of W.R. Bassick, 3 CCH Tax Ct. Mem. 1234, 1236 (1944).

Even if not zero, the fair market value might be so laden with risks or uncertainties as to be not determinable with a reasonable degree of accuracy. If so, no receipt of fair market value need be reported. This is the "open transaction" exception that the Supreme Court adopted in 1931 in *Burnet v. Logan*.⁴⁴ The Internal Revenue Service, however, has resisted this exception most vigorously. The Treasury Regulations state that the value of property will be deemed not determinable "only in rare and extraordinary cases."⁴⁵

The applicability of the "open transaction" exception to public stock would seem precluded entirely. After all, public stock, by definition, is stock that is readily tradable on an established market at a listed price. The applicability of the "open transaction" exception to private stock would be possible only in the most unusual cases. The Second Circuit held during the Great Depression, for example, that stock representing 100% of the outstanding shares of a new corporation received by a husband and wife in exchange for certain real estate was not taxable because "owing to the condition of the market there can be no reasonable expectation" that the stock could be sold in an arm's-length transaction.⁴⁶ In virtually all other cases, the courts have strained to find value. In a 1928 case, for example, the Board of Tax Appeals found that stock had a value equal to par even though the only shares sold at that price were sold by a "high pressure" stock brokerage firm.⁴⁷ In another case, the Seventh Circuit upheld the Commissioner's determination of value even though the only expert witness testified that valuation would be "simply guess work."⁴⁸ There had been no sales of the stock, "nor was there any market for it during 1922 or 1923."⁴⁹

A second exception to the prevailing rule permits a receipt of property to go untaxed if it is subject to risks of forfeiture or restrictions on its transfer. This exception differs from the first in that these risks and restrictions are artificial. They do not inhere in the nature of the property, but rather are placed on

⁴⁴ 283 U.S. 404 (1931). In *Burnet*, the Court permitted certain contingent mineral interests to remain unvalued. See also *Stephen H. Dorsey*, 49 T.C. 606 (1968); Rev. Rul. 68-194, 1968-1 CUM. BULL. 87.

⁴⁵ Treas. Reg. § 1.1001-1(a) (1957); Rev. Rul. 58-402, 1958-2 CUM. BULL. 16.

⁴⁶ *Mount v. Commissioner*, 48 F.2d 550 (2d Cir. 1931). The transfer in *Mount* would be tax-free today under § 351, but the 1918 Act had no corresponding provision.

⁴⁷ *E.F. Huffman*, 14 B.T.A. 808 (1928).

⁴⁸ *Marshall Field, Glore, Ward & Co.*, 16 B.T.A. 1299, 1306 (1929), *aff'd sub nom. F.G., Inc. v. Commissioner*, 47 F.2d 541 (7th Cir. 1931).

⁴⁹ *Id.* at 1303.

the property, usually by the transferor. A partial restriction will result in a partial diminution of value. Absent unusually high dividends, stock that is restricted so that it can be sold only to the issuing corporation for one dollar per share will not have a value in excess of one dollar.⁵⁰ In 1937 the Supreme Court combined the two exceptions in *Helvering v. Tex-Penn Co.*⁵¹ and found certain stock to be "highly speculative" as well as subject to "a restrictive agreement" that made sale of the stock "impossible." Accordingly, the stock "did not have a fair market value, capable of being ascertained with reasonable certainty."⁵² If this second exception must rest on a finding that sale is "impossible," it is indeed a narrow exception.

This second exception has also been faring poorly on the legislative front. In 1969, Congress adopted section 83 of the Internal Revenue Code, which requires that the value of property received for services not be reduced and its taxation not be deferred for insubstantial risks of forfeiture or temporary restrictions on transfer. Even permanent restrictions on transfer, under section 83, will not prevent current taxation although they may serve to reduce or eliminate fair market value.⁵³

It will be assumed for present purposes, however, that no such artificial risks of forfeiture or restrictions on transfer exist. Likewise, it will be assumed that all stock being considered, public and private, has an economic value greater than zero. Accordingly, under present law all public stock and most private stock received would be deemed receipts of fair market value.

B. *The Taxation of Receivables*

The rules just discussed have given way to an entirely different set of rules in the case of receivables. It is to these latter

⁵⁰ See, e.g., *McDonald v. Commissioner*, 230 F.2d 534 (7th Cir. 1956); *Harold H. Kuchman*, 18 T.C. 154 (1952).

⁵¹ 300 U.S. 481 (1937).

⁵² *Id.* at 499.

⁵³ Section 83 was intended to end certain tax advantages from compensation received in stock or other property that was subject to temporary restrictions on its transfer or to risks of forfeiture which were intended to reduce or eliminate its present market value temporarily for tax purposes. The artificially lowered value would be taxed as ordinary income and then, when the restrictions lapsed, the stock would return to its full value. Such increase, however, would be taxed only when the stock was sold, and then at capital gains rates. See S. REP. NO. 91-552, 91st Cong., 1st Sess. 120 (1969). The problem continues outside the payment-for-services area now covered by § 83. See *North Am. Oil Consol. v. Burnet*, 286 U.S. 417 (1932); *Boyce v. United States*, 405 F.2d 526 (Ct. Cl. 1968); Rev. Rul. 66-347, 1966-2 CUM. BULL. 196.

rules that we must now turn because, as already noted,⁵⁴ private stock should be recognized for what it really is, a receivable.

Taxation of any receivable is initially dependent on the taxpayer's method of accounting. The basic methods recognized for tax purposes are the cash method and the accrual method.⁵⁵ In addition to these basic methods, section 446(c)(3) refers to various special methods for certain transactions, such as the installment method,⁵⁶ the long-term contract method,⁵⁷ and the crop method.⁵⁸ The basic methods are not entirely elective; for instance, the accrual method is generally mandatory when inventories are used.⁵⁹ Certain sections mandate the cash method, or provide special rules for certain deductions, regardless of the method generally used by the taxpayer.⁶⁰ Section 446(c)(4) expressly permits the Internal Revenue Service to approve hybrid methods consisting of combinations of the foregoing. In all cases, the method used must "clearly reflect income."⁶¹

In general, under the cash method, a "mere receivable" is not taxable; the taxpayer can defer taxation until he receives the underlying payment.⁶² Under the accrual method, a receivable that represents an unrestricted right to receive payment at some time in the future is taxable currently. This is the basic difference between the two methods. The rules for taxation of receivables under both the cash and accrual methods are more lenient than the rules governing the taxation of other receipts. Under the cash method, taxation will not occur if the receivable is a "mere receivable," that is, if the receivable is not the "equivalent of cash" and does not involve "constructive receipt" of the underlying debt.⁶³ Under the accrual method, an unrestricted right to receive will not be found unless "all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."⁶⁴ These

⁵⁴ Text accompanying notes 27-30 *supra*.

⁵⁵ INT. REV. CODE OF 1954, § 446(c)(1)-(2).

⁵⁶ INT. REV. CODE OF 1954, § 453.

⁵⁷ Treas. Reg. § 1.451-3 (1957).

⁵⁸ Treas. Reg. § 1.61-4, T.D. 7198, 1972-2 CUM. BULL. 166.

⁵⁹ Treas. Reg. § 1.446-1(c)(2)(i) (1957).

⁶⁰ INT. REV. CODE OF 1954, §§ 71, 170, 213, 214, 215.

⁶¹ INT. REV. CODE OF 1954, § 446(b). *See, e.g.*, Commissioner v. Kuckenberg, 309 F.2d 202 (9th Cir. 1962), *cert. denied*, 373 U.S. 909 (1963); Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324 (1971), *aff'd*, 496 F.2d 876 (5th Cir. 1974).

⁶² Nina J. Ennis, 17 T.C. 465 (1951).

⁶³ *Id.*

⁶⁴ Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

rules are in addition to the general rules for determining the existence of fair market value.⁶⁵

This difference in the tax treatment of receivables as compared with other receipts is open to some criticism. Still, the discrepancy is, perhaps, not surprising because in the case of a receivable, the government has two opportunities for taxation. If the receivable itself is not taxed, the government will be able to tax later as the underlying payments are received. If the property is not a receivable, the government must either tax currently or not at all.

There is another practical reason why the rules governing receivables are properly more lenient. The taxability of property other than receivables generally does not vary with the taxpayer's method of accounting. The result is the same regardless of whether the cash or accrual method is adopted. In the case of receivables, however, if all receivables were taxable at their estimated fair market values, the basic difference between the cash method and accrual method of accounting would be eliminated.

On the conceptual level, moreover, the general rules of *Burnet v. Logan*⁶⁶ and the Treasury Regulations⁶⁷ focus only upon the measurement of "fair market value." To be currently taxable, they require only that the fair market value of the received property be determinable with a reasonable degree of accuracy. The result is no more than a reasonably reliable estimate of what the fair market value should be; it is only a theoretical fair market value, an "intrinsic value." "Fair market value depends on the market and not on intrinsic worth."⁶⁸

For most property, actual marketability may be presumed to exist given an estimable intrinsic value.⁶⁹ For receivables, however, the existence of actual present marketability cannot be presumed automatically to follow. It is often misleading to estimate an "intrinsic" fair market value from the existence of legal rights to receive payment in the future and then to proceed to treat the estimates as fair market value.⁷⁰ Actual present marketability

⁶⁵ Treas. Reg. § 1.1001-1(a) (1957).

⁶⁶ 283 U.S. 404 (1931).

⁶⁷ Treas. Reg. § 1.1001-1(a) (1957).

⁶⁸ *E.g.*, Frank Champion, 19 CCH Tax Ct. Mem. 253 (1960), *rev'd on other grounds*, 303 F.2d 887 (5th Cir. 1962).

⁶⁹ *See* Warren Jones Co., 60 T.C. 663, 671 (1973) (Tannenwald, J., dissenting), *rev'd*, 7 P-H 1975 FED. TAXES ¶ 75-5276 (9th Cir. Sept. 22, 1975).

⁷⁰ *See* S. SURREY, W. WARREN, P. McDANIEL & H. AULT, 1 FEDERAL INCOME TAXATION—CASES AND MATERIALS 867 (1972) (observing that in cases involving cash basis

must be determined separately from fair market value. This is what the "equivalent to cash" test does under the cash method and what the "all events" test does under the accrual method.

1. The Cash Method

a. *Equivalent to Cash*

The basic rule under the cash method is that a receivable, to be currently taxable, must be the "equivalent of cash"; mere intangible rights to receive property in the future are not in taxable form if they are not the equivalent of cash. This is true even though the receivables might possess "intrinsic" fair market value under the general rules.

Receivables in negotiable form usually are the equivalent of cash. Promissory notes that are readily tradable in an established market are clearly the equivalent of cash.⁷¹ Promissory notes that are not so readily tradable but that are still legally negotiable also are considered the equivalent of cash⁷² unless it can be shown that the notes are not marketable under the general rules, because, for example, the obligor is insolvent.⁷³

Mere contract rights to receive payments, however, have caused problems for many years. In several early cases, the Tax Court held that a contract of sale unaccompanied by a negotiable promissory note or other similar evidence of indebtedness simply was not equivalent to cash.⁷⁴ Later, the Tax Court, while continuing to hold that mere contracts unaccompanied by negotiable promissory notes were not the equivalent of cash, began to buttress its opinions with factual discussions of why the contracts themselves also were not equivalent to cash because they lacked marketability. The court often stressed the large discounts that the taxpayer would have to suffer if he were to sell the contracts.⁷⁵

taxpayers "[o]bligations that are not readily transferable . . . are almost conclusively presumed not to have a market value" and labeling the courts' approach "proper.").

⁷¹ Such promissory notes do not even qualify for deferred taxation under the more lenient installment sale provisions. INT. REV. CODE OF 1954, § 453.

⁷² E.g., *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Harry L. Barnsley*, 31 T.C. 1260 (1959); *A.B. Culbertson*, 14 T.C. 1421 (1950) *acquiesced in*, 1950-2 CUM. BULL. 1; *Shafpa Realty Corp.*, 8 B.T.A. 283 (1927). For these notes the installment sale provisions provide an opportunity for deferral not available under the cash method (assuming that the other requirements of § 453 are satisfied).

⁷³ *R.V. Board*, 18 B.T.A. 650 (1930).

⁷⁴ *Alice G.K. Kleberg*, 43 B.T.A. 277 (1941); *C.W. Titus Inc.*, 33 B.T.A. 928 (1936); *D.M. Stevenson*, 9 B.T.A. 552 (1927).

⁷⁵ *Western Oaks Bldg. Corp.*, 49 T.C. 365 (1968). See *Estate of Coid Hurlburt*, 25

Meanwhile, in 1961 the Fifth Circuit squarely held in *Cowden v. Commissioner*⁷⁶ that the existence of a negotiable promissory note was not a *sine qua non* for cash equivalency. The court formulated a test for the cash equivalency of contract rights which required that the contractual obligation be "unconditional and assignable, not subject to set-offs, and . . . of a kind that is frequently transferred to lenders or investors at a discount not substantially greater than the generally prevailing premium for the use of money"⁷⁷ This test is a far cry from the *Burnet v. Logan*⁷⁸ "open transaction" doctrine and the "rare and extraordinary" test of the Treasury Regulations.⁷⁹ In *Cowden* the Fifth Circuit clearly preserved the cash equivalency test as a separate test from the general rules governing fair market value.

In the Tax Court, this issue came to a head in 1973 in *Warren Jones Co.*⁸⁰ The full court, with three judges dissenting, adopted the *Cowden* approach. The majority found that a standard form real estate contract had a reasonably ascertainable fair market value and was marketable. Because of their further finding that a discount of about forty percent would have been required to sell the contract currently, however, the majority held that the *Cowden* test was not met. On appeal, the Ninth Circuit reversed and held that the fair market value was taxable in spite of the forty-two percent discount that separated the fair market value from the face value of the contract.⁸¹ The court attempted to distinguish *Cowden* in a footnote with the observation that the Fifth Circuit did not intend to establish a test for cash equivalency, but rather was engaged in "a description of the obligation in that case."⁸² The thrust of the Ninth Circuit opinion, however, was either to reject altogether the cash equivalency test or automatically to assume cash equivalency upon a finding of fair

T.C. 1286 (1956); Nina J. Ennis, 17 T.C. 465 (1951); Harold W. Johnston, 14 T.C. 560 (1950). These courts stress that unless the "equivalent to cash" test is maintained separate from the "ascertainable fair market value" test, the distinction between the cash and accrual methods will be eliminated.

⁷⁶ *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961), *rev'g*, 32 T.C. 853 (1959). See Rev. Rul. 68-606, 1968-2 CUM. BULL. 42. The "readily salable" test adopted for installment obligations seems to be a partial concession to *Cowden*.

⁷⁷ 289 F.2d 20, 24 (1961).

⁷⁸ 283 U.S. 404 (1931).

⁷⁹ Treas. Reg. 1.1001-1(a) (1957).

⁸⁰ 60 T.C. 663 (1973), *rev'd*, 7 P-H 1975 FED. TAXES ¶ 75-5276 (9th Cir. Sept. 22, 1975).

⁸¹ *Commissioner v. Warren Jones Co.*, 7 P-H 1975 FED. TAXES ¶ 75-5276 (9th Cir. Sept. 22, 1975).

⁸² *Id.* at 75-5959 n.9.

market value.⁸³ The Fifth Circuit, by contrast, treated a separate finding of cash equivalency as a prerequisite to the taxability of contract rights, and remanded for further proceedings to that end.

Most contract rights, even if legally assignable, are not of a kind frequently transferred and may be transferred only subject to all of the defenses to payment that could have been asserted against the original holder, and to the same underlying warranties and other specific obligations which were binding upon the original holder. If the contract rights are desired to be transferred without these corresponding defenses, warranties, and obligations, the specific consent of the other parties to the contract is necessary. Even then, the enforceability of the contract rights by the new holder may be conditioned upon discharge of the corresponding defenses, warranties, and obligations by the original holder.

Private stock is more akin to contract rights than to negotiable promissory notes because its legal rights to receive are not negotiable. Although assignable, these rights are conditional, subject to set-offs, and not of a kind frequently transferred to lenders or investors.⁸⁴ The discount rate probably would be far greater than the prevailing premium rate (interest rate) for the use of money. In *Warren Jones Co.*, the Tax Court measured the discount rate by comparing the actual market price with the face amount. In the case of stock, the face amount would be the capitalized value of the average annual earnings. The capitalization rate would then be the discount rate. In private corporations, capitalization rates of twenty-five to fifty percent are not uncommon.⁸⁵ These rates would not compare favorably to prevailing interest rates for money of, say, eight to twelve percent, and thus do not meet the test for cash equivalency under *Cowden* and the Tax Court's test in *Warren Jones Co.*

Public stock, on the other hand, truly is the equivalent of a negotiable instrument. It clearly meets all of the *Cowden* criteria by reason of the established stock market in which it is readily tradable. Therefore, even if public stock is first considered a receivable, it easily satisfies the equivalent-to-cash test. If not

⁸³ *Id.* at 75-5957 n.6. The court declined to choose between these two theories for its decision, noting that the outcome would be the same in either case.

⁸⁴ Of course, private stock that is subject to a buy-sell agreement is not even freely assignable and provides the clearest example of stock that is not equivalent to cash.

⁸⁵ See A. DEWING, *supra* note 35, at 390-91.

considered a receivable, it just as easily falls outside the *Burnet v. Logan*⁸⁶ "open transaction" doctrine and the "rare and extraordinary" test of the Treasury Regulations.

b. *Intent as Payment*

There is a second issue in determining whether there has been a receipt of fair market value: whether the transfer was intended as a present payment. The courts have entirely overlooked this issue in the context of stock receipts; this is surprising because the issue has played an important role in the decisions of the Second Circuit and the Tax Court on the taxation of promissory notes.⁸⁷ These cases focus upon the "receipt" half of the "receipt of fair market value" element. In the case of promissory notes, even if the notes are in fact equivalent to cash in terms of negotiability, no income will result if the notes are not "intended as payment" but only as evidence that payment will be forthcoming in the future.

The distinction in these cases may at first be difficult to understand because, of course, no noteholder is interested only in the piece of paper representing the note, just as no stockholder buys stock certificates, at least at their full market value, to frame and hang on the wall. These cases do not rest on this superficial distinction; nor do they turn on the mere temporary holding of a note as security or collateral for the eventual payment of some *other* debt.⁸⁸ Such temporary holding would not be a taxable receipt simply because no title had passed; that notes or stock were involved, as contrasted with any other property, would be irrelevant. Rather, the distinction in these cases is based on the recognition that a note can have two values: It can have a present realizable market value and a future value consisting of rights to receive payments of cash or other property in the future. It is true, of course, that the future receivable value often directly affects the present market value. It does not automatically follow, however, that an estimate of present value based on the future receivable value (an estimate of the "intrinsic value") will equal the actual present *market* value. It may be that a note has a future receivable value but no realizable present value; or

⁸⁶ 283 U.S. 404 (1931).

⁸⁷ *Schlemmer v. United States*, 94 F.2d 77 (2d Cir. 1938); *Arthur G. Kniffin*, 39 T.C. 553 (1962); *Jay A. Williams*, 28 T.C. 1000 (1957); *Robert J. Dial*, 24 T.C. 117 (1955).

⁸⁸ See *D.D. Oil Co. v. Commissioner*, 147 F.2d 936 (5th Cir. 1945). But see cases cited note 87 *supra*.

it may be that a note has both values. It may also be that, although a note has both values, the transferor intended to transfer, and the taxpayer intended to receive, only the future receivable value. A number of cases have held, in such circumstances, that no taxable receipt has occurred.⁸⁹ Thus far, this result has been restricted to notes and leases. The same argument apparently has not even been urged with respect to stock.

Some writers have made an analogous argument that taxation of capital gains should be eliminated because such gains are not true income, but are simply a part of the total capital fund that will be invested and reinvested to produce true future income in the form of inventory sales, salaries, interest, rent, dividends, royalties, and other income from the *use* of property.⁹⁰ The legislative history of capital gains, in fact, shows that one original reason for taxing capital gains at one-half of the ordinary rate was to strike a compromise between those who thought capital gains not to be income at all and those who thought capital gains equal to any other increase in wealth.⁹¹

It is not necessary to agree with these writers that capital gains taxation ought to be repealed, however, to see the logic of extending the promissory note rules to private stock. If there is any one dominant characteristic that separates private stock from public stock it is that the future receivable value (dividends and liquidating payments) is the primary value of private stock while the present realizable market value is the primary value of public stock.

Of course, the subjective intent of a stockholder could conceivably be contrary to these primary values. Still, a public stockholder should not be allowed to complain that he cared nothing at all about the strong present market value of his stock. A public stockholder may have purchased the stock strictly for its dividends, but it would be hard to deny that he had also "received" the present market value of the stock. To deny receiving

⁸⁹ Cases cited note 87 *supra*.

⁹⁰ See 1-6 HOUSE COMM. ON WAYS AND MEANS, GENERAL TAX REFORM—PANEL DISCUSSIONS, 93d Cong., 1st Sess. 35-45, 153-69 (1973); Smith, *Tax Treatment of Capital Gains*, in 2 HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 1233-41 (Comm. Print 1959).

⁹¹ See Clark, *The Paradox of Capital Gains: Taxable Income that Ought Not To Be Currently Taxed*, in 2 HOUSE COMM. ON WAYS AND MEANS, TAX REVISION COMPENDIUM 1243-56 (Comm. Print 1959). The general history of capital gains taxation through 1948 is reviewed in Wells, *Legislative History of Treatment of Capital Gains Under the Federal Income Tax, 1913-1948*, 2 NAT'L TAX J. 12 (1949).

this strong present market value would be tantamount to arguing that the receipt of dollar bills carried with them no value until spent.

A private stockholder, on the other hand, could much more easily claim that although his private stock could have been sold, with some difficulty, he did not care about that fact and thus did not receive any current benefit from it. Indeed, although the cases have looked to the subjective intent of the taxpayer,⁹² it would seem just as reasonable to substitute objective criteria. Thus, a private stockholder would be deemed not to have purchased his stock primarily for its present market value if there were objective evidence showing a very weak present market but a strong tie to future corporate earning.

c. *Constructive Receipt*

Assuming that the foregoing issues are resolved in favor of not taxing private stock, another question arises under the cash method. Even if private stock is not separate property that is "equivalent to cash," has the stockholder constructively received a corresponding portion of the underlying corporate properties? If so, he would be taxable currently on that underlying property.⁹³

The classic example of constructive receipt is an offer of payment by the debtor and a refusal of receipt by the taxpayer.⁹⁴ The physical setting aside of the payment by the debtor in a way for it to be claimed at will by the taxpayer also would result in constructive receipt. Interest credited to a savings account at the end of the year, for example, creates a right of withdrawal. If the right of withdrawal is immediately exercisable, the interest is deemed constructively received by the depositor even if not withdrawn.⁹⁵

Other examples involve constructive receipt inherent in the nature of the receivable. A claim check for a parked car or a laundry ticket for a bundle of shirts which have been washed clearly is not property separate from the underlying automobile or bundle of shirts. As such, "it" is not taxable. The underlying

⁹² Cases cited note 87 *supra*.

⁹³ Treas. Reg. § 1.451-2, T.D. 6723, 1964-1 CUM. BULL. 73.

⁹⁴ *E.g.*, Hamilton Nat'l Bank, 29 B.T.A. 63 (1933).

⁹⁵ "Generally, the amount of dividends or interest credited on savings bank deposits . . . is income . . . for the taxable year when credited." Treas. Reg. § 1.451-2(b), T.D. 6723, 1964-1 CUM. BULL. 73.

properties, however, would be considered constructively received if all the holder of the claim check or laundry ticket had to do was to walk in and take possession.

On the other hand, the doctrine of constructive receipt is to be applied sparingly.⁹⁶ Stock ownership and corporate control do not result in constructive receipt of corporate property as dividends,⁹⁷ liquidations,⁹⁸ or sale proceeds.⁹⁹ By the same token, no constructive receipt by a stockholder from his closely-held corporation can be based solely on the stockholder's power to collect if he wishes to do so.¹⁰⁰

The basic difference between private stock and other receivables that carry with them constructive receipt of the underlying property is this: The corporate entity serves to separate the holders of private stock from constructive receipt of the underlying corporate assets. Private stock may reflect the same risks and benefits as do the corporate assets, but the stockholder has not experienced constructive receipt of those assets. To hold otherwise would be to disregard the corporate entity *at the same time that it is being subjected to tax as a separate entity*. More importantly, to hold otherwise would be to disregard the very reason for the existence of the corporation, the profit motive.¹⁰¹ The

⁹⁶ *E.g.*, *D.D. Oil Co. v. Commissioner*, 147 F.2d 936 (5th Cir. 1945); *J.D. Amend*, 13 T.C. 178 (1949), *acquiesced in*, 1950-1 CUM. BULL. 1; *Rev. Rul. 58-162*, 1958-1 CUM. BULL. 234.

⁹⁷ "Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder." *Treas. Reg. § 1.451-2(b)*, T.D. 6723, 1964-1 CUM. BULL. 75. Mere control of the corporation, however, does not make the dividend "unqualifiedly subject to the demand." *See D.D. Query*, 13 CCH Tax Ct. Mem. 891 (1954). *See generally Avery v. Commissioner*, 292 U.S. 210 (1934).

⁹⁸ *See Thomas M. Hageman*, 29 CCH Tax Ct. Mem. 715 (1970) (by implication), *aff'd per curiam*, 446 F.2d 20 (5th Cir. 1971); *Walter A. Edwards*, 10 B.T.A. 39, *acquiesced in*, VII-2 CUM. BULL. 12 (1928); *George C. Ryder*, 2 B.T.A. 1060 (1925).

⁹⁹ *See Estate of W.F. Williamson*, 29 T.C. 51 (1957); *Harold W. Johnston*, 14 T.C. 560 (1950).

¹⁰⁰ *E.g.*, *Avery v. Commissioner*, 292 U.S. 210 (1934); *Hyland v. Commissioner*, 175 F.2d 422 (2d Cir. 1949); *R.E. Hughes, Jr.*, 42 T.C. 1005 (1964). On the other hand in *Fetzer Refrigerator Co. v. United States*, 437 F.2d 577 (6th Cir. 1971), the court found constructive receipt of a salary owed to a stockholder-employee of a family corporation because payment was authorized and reflected on the books as a tax deduction. *See also Rev. Rul. 72-317*, 1972-1 CUM. BULL. 128, which held that a corporate president had constructively received his monthly salary even though he had not drawn it because it had been authorized.

¹⁰¹ *Treas. Reg. § 301.7701-2(a)(1)* (1960) lists "an objective to carry on business and divide the gains therefrom" as one of the six "major characteristics ordinarily found in a pure corporation . . ." It is of course possible that another similar motive may serve the same function of giving the corporation some ongoing substance directed toward some future ends. Thus, a charity organized as a corporation would have a charitable motive, an educational corporation an educational motive, and so forth.

profit motive is essentially the opposite of constructive receipt; it is the motive of the stockholders to hold apart the corporate assets, not to receive them, and to use them through the corporation for future profits. When the profit motive ceases to exist altogether and the corporation is liquidated, or when it partially ceases to exist in the case of a stockholder whose stock is sold or redeemed, then, and only then, does the stockholder possess the underlying corporate assets.¹⁰²

If the doctrine of constructive receipt does not apply to private stock, it could not apply to public stock, which is even further removed from the corporate assets. Nevertheless, because public stock is the equivalent of cash it is, taken by itself, in taxable form.

2. The Accrual Method

This method basically carries over the cash method rules but adds one additional rule: A receivable is taxable under the accrual method even if it is not the equivalent of cash and even if it does not result in constructive receipt if all events have taken place that fix the rights of the taxpayer to receive payment.¹⁰³ In other words, if all events have taken place except that the due date for the receipt has not yet arrived, the receivable is income.

The relevant question in the case of private stock, therefore, is whether all events have taken place that entitle the stockholder to receive the underlying corporate assets. The answer must be no. Even in the case of a stockholder who controls enough votes to liquidate and dissolve, he must still go through the steps of authorizing the liquidation, making adequate provision for payment of creditors, and dividing the remaining property among the stockholders. This, in turn, may require sales of at least some of the assets to raise enough cash to pay creditors and to divide the remaining interests. Because, at the time he receives the stock, even a controlling shareholder may not be able to predict the extent of his corporation's indebtedness to future creditors, and, therefore, cannot determine the amount of the hypothetical

¹⁰² If no profit motive exists, and the transaction really involves the stockholder directly, the corporation will be ignored and the proceeds deemed constructively received by the stockholder. *E.g.*, *McInerney v. Commissioner*, 82 F.2d 665 (6th Cir. 1936). *See also* Rev. Rul. 75-223, 1975 INT. REV. BULL. No. 24, at 7, in which a parent corporation as stockholder was deemed to be the real liquidating entity even though the liquidated assets were in form held by its subsidiary.

¹⁰³ Treas. Reg. § 1.446-1(c)(1)(ii) (1957). The amount also must be determinable with reasonable accuracy. *Id.*

liquidating payment with "reasonable accuracy,"¹⁰⁴ accrual upon receipt is inappropriate. All these conditional, future events prevent current accrual.

Just as important is the event of the abandonment of the corporate motive.¹⁰⁵ Even assuming that a corporation is owned entirely by one stockholder so that all events are entirely within the control of that one individual, mere control over future events does not mean that those events can be disregarded as if they had already taken place. There still must be a true giving up before the corporate assets can be deemed accrued. The corporate profit motive must be given up, the corporation must cease doing business, and the proper corporate authorization for the payment must be voted.

C. *Definitions*

From the foregoing analysis, we are now in a position to attempt definitions of "public stock" and "private stock." Public stock might be defined as property that is not a receivable, or, at best, a receivable that is the equivalent of cash under the cash method of accounting by reason of its public characteristics.

Private stock, by contrast, is a receivable that is not the equivalent of cash under the cash method of accounting because it draws value primarily from its private characteristics. In this sense, private stock is not "property." In addition, although private stock is a receivable, it does not include constructive receipt of the underlying corporate assets. Under the accrual method, private stock is not taxable upon receipt because all events have not yet taken place that would entitle the stockholder to receipt of the underlying corporate assets.

The model takes the approach of defining public stock. All other stock is then private stock. This definition stresses the effect of the three public characteristics which limit value to that provided by an established market in which the stock is readily marketable.¹⁰⁶

Alternatively, the model could have defined private stock and then simply labeled all other stock public stock. This definition would have stressed the direct and dominant effect upon

¹⁰⁴ *Id.*

¹⁰⁵ *Glore v. United States*, 54-2 U.S. Tax Cas. ¶ 9593, at 46,605-06 (N.D. Ill. 1954) (possibility that the resolution authorizing the liquidation might be rescinded prevented recognition of income prior to actual receipt).

¹⁰⁶ See text accompanying notes 32-39 *supra*.

value of the private characteristics, and the legal rights to receive the corporate assets, as strengthened by control over those assets prior to actual receipt.

These definitions, of course, are not the only possibilities. They involve a considerable degree of subjectivity. More certainty could be injected by employing definitions based upon a fixed number of stockholders or a fixed dollar amount of gross or net assets above which all stock would become public stock.¹⁰⁷ A tie-in to the securities regulation laws might even be used so that, for example, stock registered under section five of the Securities Act of 1933¹⁰⁸ or subject to the reporting requirements of section thirteen of the Securities Exchange Act of 1934¹⁰⁹ would be deemed public stock while stock issued pursuant to the private offering exemption¹¹⁰ or the intrastate exemption¹¹¹ or the small-issue registration¹¹² would be private stock.

Some judgment also is necessary to strike the proper balance between the private and public characteristics. Should stock be public stock only if its value is derived exclusively or primarily from its public characteristics? Should the nature of stock simply be determined by which set of characteristics predominates? Should substantial public characteristics suffice? The model definition is restrictive in that it tends toward a requirement of strong public characteristics, but it reduces the subjectivity inherent in these adjectives by requiring an "established market on which the shares are readily tradable."¹¹³ Such a market would usually consist of trading on any of the recognized stock exchanges or on the over-the-counter market and thus could usually be objectively determined.

At this point, we might pause to consider whether the def-

¹⁰⁷ This is the approach taken in Slawson, *Taxing as Ordinary Income the Appreciation of Publicly Held Stock*, 76 YALE L.J. 623, 651-55 (1967). Slawson advocated 500 shareholders as the threshold for public corporation status. This number is also used, together with a \$1 million gross assets test, for the mandatory proxy and reporting rules of the 1934 Securities Exchange Act.

¹⁰⁸ 15 U.S.C. § 781(g) (1970).

¹⁰⁹ 15 U.S.C. § 78m (1970).

¹¹⁰ Securities Act of 1933 § 4(2), 15 U.S.C. § 77d(2) (1970).

¹¹¹ Securities Act of 1933 § 3(a)(11), 15 U.S.C. § 77c(a)(11) (1970).

¹¹² Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1970).

¹¹³ This test would preclude not only the cash and accrual methods from resulting in tax-free treatment for receipts of public stock, but also the installment method. Section 453(b) of the Internal Revenue Code of 1954 expressly excludes corporate notes which are readily tradable on an established market. Treas. Reg. § 1.421-6(c)(2) (1961) also employs this same test to distinguish taxable from non-taxable (non-qualified) stock options.

inition ought to be broadened so as to include corporate debt (accounts and short-term notes as well as long-term debentures and bonds) in addition to stock. After all, we have arrived at this point partly by stressing the similarities between private stock and receivables, and debt and securities are obviously receivables. What would be wrong with dividing corporate debt into public debt and private debt and treating the former as separate property and the latter as not? Public debt is frequently as readily tradable as public stock.

Under the accrual method, however, private debt should remain taxable. Because of the fixed payment dates, fixed principal sums, and fixed interest rates of most corporate debt, "all events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy."¹¹⁴ Also, private debt in the form of negotiable notes should remain taxable as it now is, even under the cash method (unless the lack of intent to receive as payment were established), because of its cash equivalency.

In other words, it would seem best to focus on stock for present purposes simply because certain important private characteristics of private stock usually differ from those of private debt. In fact, it should be these very characteristics that should be examined to differentiate between stock and debt.¹¹⁵

IV. STOCK AS "SEPARATE" PROPERTY: A TRANSACTIONAL ANALYSIS

In Part II public stock was found in economic effect to be "separate property" and private stock to be a mere conditional receivable. Part III explored the legal effect of this distinction in relation to the requisite existence of "fair market value." Public stock was found to possess such value, but it was argued that private stock does not. Part III also explored the "receipt" element in connection with the argument that private stock should be considered a temporary, rather than permanent, re-

¹¹⁴ Treas. Reg. § 1.446-1(c)(1)(ii) (1957).

¹¹⁵ By continuing to separate stock and debt, the model does not eliminate the problems of distinguishing between the two. The model does suggest, however, that the question whether to reclassify particular private securities or other debt as "stock" be resolved by reference to whether they possess the private characteristics of private stock, that is, whether they, too, fail the "equivalent to negotiable" test of *Cowden v. Commissioner*, 289 F.2d 20 (5th Cir. 1961). See generally *Tomlinson v. 1661 Corp.*, 377 F.2d 291 (5th Cir 1967).

ceipt. In the transactional analysis that follows we shall consider two additional distinguishing features of public stock and private stock which depend entirely upon the transaction in which the stock is involved: (1) Is an exchange involving stock really a disposition to an outside entity and thus a "realization?" (2) Is the stock property of "like kind" to the property exchanged for it?

Under present law, gain or loss is taxed not as it builds up through the appreciation or depreciation of property, but rather at such time as the property is disposed of to an outside entity usually in exchange for new property or services.¹¹⁶ Even if gain or loss is thus technically "realized," however, the realization transaction may be disregarded (not "recognized") if it is not meaningful, that is, if the property received is of like kind to the property given up.¹¹⁷ In addition, the transaction may be disregarded if the disposition is not to an outside entity, that is, if the taxpayer in effect disposes of property to himself.¹¹⁸ These "realization" and "like kind" rules underlie the present tax-free treatment accorded certain incorporation transfers,¹¹⁹ stock dividends,¹²⁰ and reorganization exchanges.¹²¹ Other transactions that are essentially the reverse of these transactions (stock redemptions,¹²² cash dividends¹²³ and liquidations¹²⁴) nevertheless are treated under present law as meaningful transactions and thus are taxable.

A. *Incorporations*

Pursuant to section 351, transfers of property to a corporation solely in exchange for stock or securities, even if the property has appreciated or depreciated in value, are tax-free to the transferors if they end up with control, that is, if they own at least eighty percent of the corporation's stock immediately

¹¹⁶ INT. REV. CODE OF 1954, § 1001.

¹¹⁷ *E.g.*, INT. REV. CODE OF 1954, §§ 1031-39.

¹¹⁸ Income from disposition to oneself may be likened to so-called "imputed income" which arises out of a taxpayer's dealings with his own property and which is arguably not constitutionally taxable under the sixteenth amendment. *See Helvering v. Independent Life Ins. Co.*, 292 U.S. 371, 374 (1934).

¹¹⁹ INT. REV. CODE OF 1954, § 351.

¹²⁰ INT. REV. CODE OF 1954, § 305(a).

¹²¹ INT. REV. CODE OF 1954, §§ 354, 361.

¹²² INT. REV. CODE OF 1954, § 302.

¹²³ INT. REV. CODE OF 1954, § 301.

¹²⁴ INT. REV. CODE OF 1954, § 331.

thereafter.¹²⁵ The reason for this tax-free treatment, as stated in the Senate Finance Committee report, is the thought that the mere placing of a corporate shell around property is not a realization of any appreciation or depreciation in its value.¹²⁶ A receipt of stock for services, on the other hand, is outside section 351 and is taxable on the theory that the stock represents a true receipt of compensation.¹²⁷

If control does not end up with the transferors, however, section 351 does not apply. The gain or loss relating to each asset transferred then is taxed at ordinary rates or at capital gains rates, depending upon the nature of each such asset. The relevance of the control test is in its relation to the continuity of interest that the controlling stockholders maintain in the underlying corporate assets. If continuity is maintained, no meaningful disposition of assets has really taken place. If no continuity is maintained, the stockholders are taxed currently under the present statute, on the theory that they have, in effect, sold out to others.¹²⁸

1. The Private Stockholder

Section 351 seems to bring about an obviously correct result in the case of a corporation owned entirely by one stockholder because his private stock is little more than the alter ego of the property given in exchange for it. Although there has been a disposition to an outside entity, and hence a realization, the incorporation event is a classic example of a like-kind exchange. The corporation, although technically a separate entity for tax purposes, is so closely related to the stockholder that a disposition from one to the other should be disregarded.

What of the argument, though, that even a transfer qualifying for non-recognition under section 351 results in a true exchange if more than one transferor is involved? For example,

¹²⁵ The control requirement is 80% of the total combined voting power and 80% of the total number of shares of all other classes of stock. INT. REV. CODE OF 1954, § 368(c).

¹²⁶ S. REP. NO. 275, 67th Cong., 1st Sess. 11 (1921). See *Portland Oil Co. v. Commissioner*, 109 F.2d 479 (1st Cir. 1940). The 1921 committee report noted that "fictitious" exchanges resulting in losses also would be barred by the predecessor to § 351, thus considerably increasing the revenue.

¹²⁷ H.R. REP. NO. 1337, 83d Cong., 2d Sess. A117 (1954). Although this rule was understood under prior acts, § 351 was amended in 1954 expressly to include stock for services.

¹²⁸ See *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949).

suppose that *A* has a building and *B* has some equipment of equal value. If *A* and *B* transfer their respective assets to a newly formed corporation, each in exchange for fifty percent of the stock, it can be argued that each indirectly has exchanged his separate asset for undivided one-half interests in the building and the equipment. In substance, *A*, who formerly owned the building, has exchanged an undivided one-half interest in his building for an undivided one-half interest in *B*'s equipment, and vice versa. A direct exchange of building-for-equipment clearly would be taxable. A seemingly identical exchange effected through a corporation is rendered non-taxable by section 351 if the transferors, as a group, end up with control.¹²⁹ Why? The stock, even if equated to the new underlying property interests, is different from each separate old property given up. If it is property at all, it certainly is not like-kind property. Moreover, there may well have been a relinquishment of control, notwithstanding satisfaction of the eighty percent ownership test of section 368(c). The transferors need not be related to each other. Once the incorporation transfers are completed, they may never again exercise their shares to control the corporation in harmony with each other. Section 351, however, presumes such proprietary harmony.

The real reason supporting non-recognition is that *A* and *B* have come together and have relinquished their old property interests, but they have not yet drawn down their new property and gone their separate ways. The exchange of building-for-equipment has not yet been completed. There has been no "receipt" of value.

To be sure, this is also true of direct taxable exchanges of undivided one-half interests that do not involve a corporation to the extent that "receipt" refers to a physical severance of *A*'s property from *B*'s. There is, however, a difference: As we saw in Part III, private stock is no more "property" than any other contingent contract rights. The use of a corporation reflects the dominant intent of *A* and *B* that their old properties will remain in the corporate enterprise to be used jointly¹³⁰ and to produce future earnings and profits from such use. This dominant intent, this "profit motive," overshadows the technical receipt of

¹²⁹ See S. REP. NO. 1622, 83d Cong., 2d Sess. 264 (1954).

¹³⁰ See *American Compress & Warehouse Co. v. Bender*, 70 F.2d 655, 657 (5th Cir.), cert. denied, 293 U.S. 607 (1934); Treas. Reg. § 1.351-1(a)(1) (1955).

new property interests. If successful, the corporation will pay a tax on its future earnings and profits, and *A* and *B* will then pay individual dividend taxes as the earnings and profits are distributed. In the meantime, the "profit motive" prevents the underlying technical exchanges of property interests from being completed. For all we know, if and when their "profit motive" is at an end and the corporation is liquidated, *A* and *B* might decide that each is to receive back his original property, and the exchange of building-for-equipment might never be completed.

A corporation, of course, is not the only possible vehicle to carry out a "profit motive." A partnership also could be used, and the present statute provides for a similar tax-free result.¹³¹ Indeed, under the statutory definition of "partnership" a simple joint venture would qualify.¹³² In other words, a taxable exchange between *A* and *B* is rendered non-taxable simply by adding a "profit motive."

Continuing this line of reasoning, however, leads to a question at the other end of the spectrum. What is the necessity for the control requirement in section 351? Is it a prerequisite to a "profit motive"? Clearly not. The tax-free status of transfers to partnerships does not depend upon control.¹³³ Why then should the section 351 benefits be limited only to transfers by controlling stockholders? Why should not any transfers of property to private corporations in exchange for private stock be tax free? The potential gain in the property so transferred has not yet been realized because of the same "profit motive." The "profit motive" can be just as strong as for controlling transferors. Indeed, a non-controlling private stockholder would seem further from any actual realization of gain than a private stockholder who had control of the underlying corporate assets.

Section 351, as noted, focuses upon what is or is not *given up*. If control is given up, the transaction is deemed taxable. If control is retained, the assets in effect are retained. The "profit motive" approach focuses upon what is *received*. If the "profit motive" intervenes, nothing but the private stock is received. The "profit motive" prevents the exchange of undivided interests in the underlying corporate assets from being completed.

Continuing even further, why should the receipt of private

¹³¹ INT. REV. CODE OF 1954, § 721.

¹³² INT. REV. CODE OF 1954, § 7701(a)(2).

¹³³ INT. REV. CODE OF 1954, § 721.

stock for services be a taxable event? The present requirement of section 351, that the transfer be of property, is intended to exclude stock that is a true receipt of compensation.¹³⁴ If the stock received is private stock, however, the only thing that has been received is the right to receive a future share of any distributed corporate property. The private stock is no more than a piece of paper evidencing the recipient's "profit motive" and corresponding legal rights to receive a share of the profits.¹³⁵

In summary, the historical reasons for non-taxation under section 351 are that the stock received is property of "like kind" to the property given up and that there is no meaningful realization because the controlling transferors are able to preserve a continuity of interest in the property through stock control. Upon examination, these reasons are seen to rest upon the tenuous assumptions that the controlling transferors will continue to act in harmony with one another and that non-controlling transferors cannot achieve this relationship. A much better approach would be reliance upon the "profit motive" which would make section 351 applicable to all transfers of goods or services to private corporations in exchange for stock.

2. The Public Stockholder

Exchanges between a private corporation and its stockholders contrast dramatically with a typical issuance of public stock. The giving up of the public stockholder's property and the receipt of public stock is a complete exchange. The stockholder has parted with his property, and he cannot get it back unless he is able to "buy" it back in the future by coming to a new agreement with a corporation he probably does not control. Even if he does possess control, the public stock he receives is true separate property with a separate market value. The exchange has been meaningful and permanent; old property has been permanently exchanged for new and different property.

The present statute at least partially reflects these facts. The control requirement usually operates to exclude transfers to public corporations from section 351. Thus, in the typical case, the stockholder would be taxed on the difference between the value of the stock received and the adjusted basis of the assets given

¹³⁴ See note 127 *supra*.

¹³⁵ Cf. Rev. Rul. 60-31, 1960-1 CUM. BULL. 174 (deferred compensation arrangements).

up.¹³⁶ The same result would obtain as if he had simply sold his assets for cash.

Section 351 would apply to the theoretical case of a transfer by a controlling group of stockholders to their public corporation. Because control for section 351 purposes means at least eighty percent of the stock, however, the remaining twenty percent would have to be very widely scattered indeed to render the corporation a public corporation.¹³⁷ By replacing the control requirement with a more realistic division of public stock and private stock (based primarily upon the existence of an established stock market for the shares) this situation would be avoided.

Even though it is unlikely that public stockholders could use present section 351, that provision presents a broader issue: How should stock that possesses the characteristics of both public stock and private stock be treated? As noted earlier, within each share of public stock is a share of private stock. All public stock legally possesses the same private rights as private stock. The difference presented by this issue is that these private characteristics may be presumed to have real value.

It would seem better, however, to treat all such stock as public stock. Although it is true that private aspects which represent rights of real value to the stockholder would tend to reduce the exclusive importance of the stock's public aspects, the absolute value of the stock's public aspects would not be reduced and might be enhanced. The stock is still clearly separate property even though it possesses other valuable non-separate property aspects. It should therefore be taxed as separate property.

3. The Private Corporation

From the standpoint of the private corporation, its issuance of private stock in exchange for property is not a completed transfer. The corporation has completed neither a "purchase" of the property received nor a "sale" of its stock. It has just temporarily received property of the stockholders to be used as directed by officers and directors who, in turn, are under the direct and meaningful control of the stockholders. The private stock given up by the corporation is thus a kind of temporary

¹³⁶ INT. REV. CODE OF 1954, § 1001.

¹³⁷ Even then, it might be argued that such a large block of stock was not "readily tradable" even though listed on an exchange.

claim check; it is not intended as payment. It evidences the temporary deposit of property in the corporation and the resulting stockholder control.

Non-recognition of gain is again clearly appropriate, and section 1032 accomplishes this result by treating the issuance of stock as a non-taxable event to the issuing corporation. Section 1032, in contrast to section 351, is not restricted to transfers involving stockholders who end up with control. All stock issuances are tax free to the issuing corporation, whether or not the stock received is tax free to the stockholders.

4. The Public Corporation

Conceptually, the most difficult question arising out of the basic difference between private stock and public stock is whether the issuance of public stock should be a taxable event to the issuing public corporation. Section 1032 makes no distinction between public and private corporations. It provides that no gain or loss shall be recognized by any corporation when it issues its own stock for money or other property.

Section 1032 may be contrasted with the general rule in section 1001 which provides that gain or loss shall be realized when a "disposition of property" takes place. The legislative history of section 1032 does not speak to this difference. The section was new in 1954, and the Senate Finance Committee report noted that the section had "no counterpart in existing law."¹³⁸

Prior to 1934, the rule was that issuances of a corporation's own stock and sales of its own treasury shares were not taxable to the corporation.¹³⁹ In 1934 new Treasury Regulations changed this rule but only as to issuances of treasury shares.¹⁴⁰ The 1954 Senate Finance Committee report described the law from 1934 to 1954 as follows:

¹³⁸ S. REP. NO. 1622, 83d Cong., 2d Sess. 426 (1954).

¹³⁹ Treas. Reg. 33, revised, art. 98 (1933). Interestingly, the reverse transaction, a sale of other property in exchange for the corporation's own stock, was held by some courts to be taxable, although the Board of Tax Appeals disagreed. *Compare* *Spear & Co. v. Heiner*, 54 F.2d 134 (W.D. Pa. 1931), *aff'd per curiam*, 61 F.2d 1030 (3d Cir. 1932), with *Houston Bros.*, 21 B.T.A. 804 (1930). The rule that stock received by the issuing corporation is taxable if appreciated property is given up survives under present law except for liquidations and certain complete redemptions of all of the stock of a stockholder. INT. REV. CODE OF 1954, §§ 311(d)(2), 336.

¹⁴⁰ Treas. Reg. 103, § 19.22(a)-16 (1934). The Supreme Court limited the new rule to prospective application. *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939).

Under present law, whether the disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends, under certain decisions, upon whether the transaction constitutes the dealing by a corporation in its own shares which is to be ascertained from all the facts and circumstances.¹⁴¹

Considerable confusion resulted. The report concluded that section 1032 was being proposed "to remove the uncertainties of present law."¹⁴²

I do not suggest that we return to the situation that existed prior to 1954. The confusion resulted from attempting to distinguish treasury stock from newly issued stock and "dealing in its own stock as that of another corporation" from merely "engaging in a capital transaction";¹⁴³ the model would disregard these distinctions and focus exclusively on the difference between public stock and private stock.

Section 1032 can be reconciled with section 1001 on the ground that section 1032 merely specifies that an issuance of stock is not a "disposition" of property and thus the property received in exchange is not a "receipt." Alternatively, section 1032 may be thought of as an exception to the general rule of section 1001 to the effect that, although an issuance of stock may technically be a realization, it is not a "meaningful" one and should therefore be ignored for tax purposes. Sections 1031 and 1033, which flank section 1032 in the Code, are both of this latter type. Like-kind exchanges in section 1031 and involuntary conversions in section 1033 technically are dispositions of property but are not considered "meaningful" dispositions because the property given up is of "like kind" or is "similar or related in service or use" to the property received. We shall now examine the soundness of both rationales as applied to public corporations.

¹⁴¹ S. REP. NO. 1622, 83d Cong., 2d Sess. 426 (1954).

¹⁴² *Id.*

¹⁴³ Compare *Dow Chemical Co. v. Kavanagh*, 139 F.2d 42, 44 (6th Cir. 1934), and *Dorsey Co. v. Commissioner*, 76 F.2d 339 (5th Cir.), *cert. denied*, 296 U.S. 589 (1935), with *E.R. Squibb & Sons v. Helvering*, 98 F.2d 69 (2d Cir. 1938), *modified*, 102 F.2d 681 (2d Cir. 1939).

a. "No 'Disposition'; No 'Receipt' "

(i) "A Stock Issuance Is Only Temporary"

A primary requirement of a "disposition" and corresponding "receipt" is that they be permanent.¹⁴⁴ If a person loans his automobile to a neighbor he has not "disposed" of it. Even if he rents it to the neighbor he has not disposed of it unless the rental term is so long and includes so many other attributes of ownership (principally, risk of loss) that it amounts to a permanent disposition.¹⁴⁵ This argument, however, applies only to a private corporation. There the shareholders have the power to undo the original issuance, liquidate the corporation and receive the corporate properties. The situation is as if the private corporation had borrowed the private stockholders' assets.

A public corporation however, clearly does not have the power to tender back the property and receive the stock it issued. It must strike a new deal with each stockholder.¹⁴⁶ It does not even have the power to liquidate and dissolve without stockholder consent. A proposal to liquidate is one of the few upon which public stockholders can be expected to exercise some independent judgment and not simply to follow the directions of corporate management.

(ii) "A Mere Capital Transaction"

This argument seems to be the main one in the pre-1954 cases holding a stock issuance not to be a taxable event to the issuing corporation:¹⁴⁷ All that public corporations were really doing by issuing stock was raising capital with which to conduct their affairs and, hopefully, to earn profits *in the future*. Had the opinion writers in these cases noted the strong similarity between private stock and promissory notes, they might simply have found that the issuing corporations had no "intent to receive the property as payment" for the stock.¹⁴⁸ The real payment would come in the form of future profits.

¹⁴⁴ This is often referred to as the "claim of right" doctrine. See *North Am. Oil Consol. v. Burnet*, 286 U.S. 417, 423-24 (1932).

¹⁴⁵ See Rev. Rul. 55-540, 1955-2 CUM. BULL. 39.

¹⁴⁶ See text accompanying notes 26-39 *supra*.

¹⁴⁷ See *United States v. Anderson*, Clayton & Co., 350 U.S. 55 (1955); *E.R. Squibb & Sons v. Helvering*, 98 F.2d 69 (2d Cir. 1938), *modified*, 102 F.2d 681 (2d Cir. 1939); *Cluett, Peabody & Co.*, 3 T.C. 169 (1944); *Dr. Pepper Bottling Co.*, 1 T.C. 80 (1942).

¹⁴⁸ See text accompanying notes 87-92 *supra*.

In the case of a public corporation, however, as in the case of the public stockholder discussed earlier, the corporation should not be heard to complain that the property it received had no present value to it. It received the property permanently and with very few restrictions on its future use or disposition.¹⁴⁹

b. *No "Meaningful" Disposition*

(i) "A Public Corporation Is Not An Outside Entity"

This argument starts with the requirement that a "meaningful" disposition must be more than a mere internal change in form. A bag of flour is not really disposed of when it is baked into loaves of bread. The loaves are not really disposed of when they are consumed directly by the baker. A disposition, to be "meaningful," must be to an outside entity.¹⁵⁰

From this, it can be argued that an issuance of shares is not a disposition even if the corporation is conceded to be an "entity" because the corporation is not an "outside" entity. Even a public corporation is a legal fiction, it can be argued, which is simply the alter ego of the stockholders. The stockholders thus are too closely related to the corporate entity. The stock, although issued, has not yet been disposed of to an outsider.¹⁵¹

This argument appears to apply only to the private corporation. There the stockholders really are insiders. A private stock issuance is an internal event. If anything, it evidences an intent to retain and use (a "profit motive") and not to dispose of the assets placed in the corporation. Because a public corporation and its stockholders are truly separate entities, however, a disposition from one to the other should be treated as a disposition to an outside entity.

(ii) "Stock Is Like-Kind Property."

Stock, of course, is intangible property. As with all intangible property, it has derivative value. It cannot be consumed di-

¹⁴⁹ In the pre-1954 (pre-section 1032) cases that held stock issuances taxable to the issuing corporation, the facts showed that the corporation was dealing in its own shares. This usually meant that there was an established market for the shares, although the decisions did not turn on this fact. See *Commissioner v. Landers Corp.*, 210 F.2d 188 (6th Cir. 1954); *Dow Chemical Co. v. Kavanagh*, 139 F.2d 42 (6th Cir. 1943).

¹⁵⁰ See note 118 *supra*.

¹⁵¹ This argument has been urged in support of § 351. See B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 3.01 (3d ed. 1971). It would seem to have equal validity for determining the taxability of the transaction to the issuing corporation.

rectly or used physically. If its derivative value were too closely tied to some other specific property, the two would be properties of like kind. An exchange of the two, therefore, would not be "meaningful."

To the extent that stock is private stock, the like-kind property argument makes sense because private stock derives its value directly from the underlying corporate assets. From the corporation's standpoint, the private stock either is the alter ego of the underlying corporate assets or simply consists of a right to receive those assets at an indeterminate future time.

Public stock, though, takes on a value all its own once it is issued. Newly-issued public stock does not derive value solely from the corporate assets; it shares in the total stock market value of the corporation's stock. This total stock market value might conceivably be thought of as itself an intangible asset of the corporation. Even so, it certainly is not of like kind to the new property received by the corporation in exchange for the newly-issued shares.

c. *The Cost of the Newly Issued Shares*

(i) No Cost?

The next question is whether parting with this property *cost* the public corporation anything. Gain is measured by the difference between the amount realized and the adjusted basis of the property given up.¹⁵² If there is no cost,¹⁵³ there is no adjusted basis and the gain to the public corporation upon issuing its own public shares would be equal to the full fair market value of the property received. Assume, for example, that a public corporation has as its only asset \$10 million in cash. If it then issued additional shares of new public stock for \$1 million cash, and if the cost of issuing that new stock were determined to be zero, the corporation would be charged with a gain of \$1 million.

On further examination, however, it becomes evident that the issuance of public stock does involve a cost to the issuing corporation. It is the same cost that is incurred by a private corporation upon the issuance of private shares; it comes from

¹⁵² INT. REV. CODE OF 1954, § 1001.

¹⁵³ The "adjusted basis" of property is usually its cost (§ 1012) less depreciation (§ 1016(a)(2)) plus capital expenditures attributable to it (§ 1016(a)(1)). Other special basis rules are used for gifts (§ 1015), inheritances (§ 1014), and like-kind exchanges (§ 1031(d)), but the text discussion assumes that these special provisions do not apply.

the private characteristics of the public stock, from the private stock within the public stock. The difference, however, is that while the private corporation never really parts with its private cost, the public corporation does.

The public corporation issues its new stock to new stockholders and receives cash or other assets in return. It thereby creates or "carves out" and then transfers to the new stockholders certain private legal rights which we have found to be equivalent to "receivables."¹⁵⁴ From the corporation's standpoint, it incurs matching legal obligations, which are spelled out primarily in the state corporation law and the corporation's articles of incorporation. These obligations mainly concern future payments of dividends and liquidating distributions and are the cost of the newly-issued shares.

(ii) Cost versus Value

Public stockholders, as noted, usually have no control over the corporation's retention, use, or distribution of assets. It might be that the prospect of a shareholder using his private rights to force a distribution of profit from such use is so remote as to reduce the present value of the legal obligations represented by the stock to zero.

On the other hand, it might be that even though direct corporate distributions are perceived to be very far off, the past success and growth of the corporation (even though earnings invariably have been retained) will lend strong support to the stock market value of the shares, and continued success may well cause market value to rise. As noted earlier,¹⁵⁵ many other outside factors may also affect that value. The point, though, is that the *value* of the legal obligations that underlie the stock is of no concern in computing gain from an issuance of public stock.¹⁵⁶ These obligations may be worth something or they may not. It is

¹⁵⁴ See *H.B. Zachry Co.*, 49 T.C. 73 (1967). The Tax Court held carved-out production payments to be "property" under § 351. Although § 636 has changed this rule for oil financings, the analogy to public stock still seems apt.

¹⁵⁵ See text accompanying notes 32-36 *supra*.

¹⁵⁶ Section 1032, by its terms, does not apply to an issuance of stock for services, but the Treasury Regulations have extended it to services. Treas. Reg. § 1.1032-1(a) (1956). Oddly, the Revenue Service has also ruled that treasury stock given for services may give rise to a deduction for business expenses under § 162(a) in an amount equal to the fair market value of the stock, as if it somehow automatically had a basis equal to its fair market value. See Rev. Rul. 62-217, 1962-2 CUM. BULL. 59, *modified*, Rev. Rul. 74-503, 1974-2 CUM. BULL. 117.

enough that they exist and that, whatever their worth, they represent a *cost* to the corporation. The value of the stock would come primarily from the stock market and presumably would be equal to its issue price. The value of public stock, then, comes from its public characteristics; its cost to the issuing corporation comes from its private characteristics.

(iii) How Much Cost?

If a corporation borrows, say, \$14,000 and signs a note for \$14,000, it does not realize income because the cost of the legal obligation to repay is deemed equal to the amount it receives. If the corporation issues stock, the legal obligation, as of that date, is to pay out a certain pro rata portion of all of the property then on hand—whatever its fair market value. If the adjusted basis for that pro rata portion of property is lower than its fair market value, this lower adjusted basis will be the current realized cost. Anything higher or lower than that would require a realization of potential gain or loss for stock issuance purposes that has not been realized for tax purposes generally.

An example may help to make this point. Assume that an existing corporation has assets with an adjusted basis of \$10,000. It has 100 shares of stock outstanding and no liabilities. Next, assume that the corporation issues 100 new shares for \$14,000 cash, their present market value. The corporation now has total assets with a combined basis of \$24,000. This divides into \$12,000 for the old stock and \$12,000 for the new. The issuance of the new stock for \$14,000 was accomplished by the corporation at a cost of \$12,000. The gain, therefore, was \$2,000. The reason that the corporation was able to sell the new 100 shares for \$14,000, of course, was because its old 100 shares were also worth \$14,000.¹⁵⁷

¹⁵⁷ In an issuance of private stock pursuant to an arm's-length transaction, the consideration received by the corporation is presumed to be exactly offset by the corresponding legal obligation to pay out a pro-rata share of the corporation's assets. That is, the consideration received is presumed to be equal to the fair market value of those assets. In an issuance of public stock, however, even pursuant to an arm's-length transaction, it does not necessarily follow that the consideration received is matched by the fair market value of a pro-rata share of the corporate assets. A portion of the consideration is for the extra value (over and above the asset's fair market value) that the public stock has on the stock market.

In the example used in the text, the \$14,000 paid for the new public shares was assumed to be matched by only \$12,000 of the fair market value of the corporate assets. The remaining \$2,000, then, was the extra value of the stock attributable to the existence of a public market for the shares. In the example, the \$12,000 fair market value was

(iv) Current Tax versus Deferral

If, instead of issuing 100 shares of new stock for the \$14,000 in cash, the corporation had issued a promissory note or bond or debenture with a face amount of \$14,000, there would have been no gain at all, present or potential. The \$14,000 cash would have been offset by the legal obligation to repay \$14,000, as represented by the debt instrument.¹⁵⁸

If private stock had been issued, the corporation's legal obligation would have been only to repay assets with a current basis of \$12,000. The difference would have been a gain of \$2,000, but this gain would not have been realized currently. It would have been a potential gain to be deferred until later when the underlying assets actually were disposed of.

What of the argument that the proper time to realize this \$2,000 gain should also be at the time of an actual disposition of the underlying assets in the case of public stock and not merely at the time the public stock is issued and the assets are used indirectly as "backing" for its value on the stock market? This question actually asks whether a public stock issuance is a temporary place-holder for a later distribution of assets, and therefore a non-taxable transaction, or whether such stock issuance is a completed taxable transaction. If the stock is private stock, the disposition transaction has not been completed and the \$2,000 gain in the example should not be recognized. In the case of

assumed to be equal to the \$12,000 adjusted basis of these assets. It is possible, of course, that the true fair market value was higher or lower than \$12,000. At one extreme, these assets might have been worth nothing at all so that the entire \$14,000 was paid solely for the extra stock market value. At the other extreme, the assets might have been worth exactly \$14,000. If so, the existence of a public market for the shares must have been worth nothing. The present statute has adopted this latter extreme.

The model rests upon an assumption that is between these two extremes, namely, that the fair market value of the corporate assets is equal to their adjusted bases. Any excess consideration received upon the public stock sale must therefore be attributable to the sale of the right to share in the extra stock market value. This assumption avoids having to value the corporate assets every time public stock is sold. It is strengthened by the fact that purchasers of public stock often lack the necessary information and power to obtain independent appraisal of the true fair market values of the assets. They do the next best thing. They rely upon published corporate reports of the book values of the assets. In this way the book values (roughly equivalent to the adjusted bases) become *in fact* working approximations of the asset fair market values.

¹⁵⁸ From the standpoint of the corporation, the mere incurring of a debt (even if represented by a negotiable note such as would be taxable to a cash method recipient) would not be deductible by a cash method obligor. See Treas. Reg. § 1.461-1(a)(1) (1960). If the corporate obligor were an accrual method taxpayer, only the current year's portion would be deductible (if otherwise qualified as a business expense).

public stock, however, this transaction is as permanent and complete as it is likely to get. Either the \$2,000 gain is taxed now or it is unlikely that it ever will be.

Conceptually, moreover, a public stock issuance is a true completed transaction. What is being sold is a share of the public stock market. The public corporation, by issuing stock, is exercising its legal right to let the stockholder receiving such stock into the market; this legal right is an intangible asset (with a zero basis) to the corporation. The public corporation is exchanging this intangible asset, together with the private legal obligations, for the assets it receives in return.

Using the figures in the example, an issuance of private stock might be analogized to *borrowing* \$14,000 by placing a \$14,000 mortgage on a piece of property already owned with a basis of \$12,000 and a fair market value of \$14,000. An issuance of public stock, in contrast, is like *buying* \$14,000 worth of property and giving in return a \$12,000 mortgage plus \$2,000 worth of property with a zero basis.

B. Dividends

Section 316 states that all distributions by a corporation to its stockholders shall be considered to be first out of earnings and profits. This section further provides that, with exceptions for liquidations and redemptions, all distributions out of earnings and profits are dividends, and that distributions that are dividends shall be included in gross income. The corporation making the distribution is usually not taxed unless certain inventory or appreciated property is distributed.¹⁵⁹

Nowhere in the present tax law is the term "earnings and profits" defined. Originally, the Treasury Regulations equated "earnings and profits" with "surplus";¹⁶⁰ surplus also is not a statutory term, but a business accounting term. Surplus, however, can be reduced simply by altering the par value of the stock, or by issuing a stock dividend, or by redeeming some shares. Moreover, accountants recognize different types of surplus: earned surplus, paid-in surplus, revaluation surplus, and many more. Earned surplus seems to be the most relevant for earnings and profits because it is generally used to collect each year's earnings and profits for book purposes. In regard to re-

¹⁵⁹ INT. REV. CODE OF 1954, § 311.

¹⁶⁰ Treas. Reg. 33, revised, arts. 106-07 (1918).

demptions, section 312(e) provides that earned surplus shall reflect certain adjustments for the part of the distribution that is properly chargeable to capital account. Other adjustments are necessary for all items that are treated differently for book purposes than for tax purposes.

1. Private Corporations and Private Stockholders

The model permits the "earning and profits" concept to be discarded altogether. In its place, a private stockholder would be taxed on the difference between the adjusted basis to the corporation of the property so distributed and the adjusted basis of his private shares deemed given up, if any. The adjusted basis of private shares deemed given up would be the amount corresponding to the decline, if any, in the stockholder's percentage share of the total stock outstanding. The bases of all identical shares owned by the same stockholder would be averaged. No losses would be recognized. The private stockholder would then simply take over the same adjusted basis that the corporation had for the property. The corporation also would recognize no gain or loss.

The theory behind taxing to the stockholder, as a dividend, the difference between the corporation's adjusted basis for the assets he received and his adjusted basis for the stock deemed given up is that this difference accurately measures his share of corporate earnings still on hand and not already distributed. To test this theory, we must first ask what it is that could possibly make the total adjusted basis of the corporate assets different from the total of the adjusted bases of the stockholders for all of their shares. The two would start out the same upon the initial incorporation transaction. Thereafter:

(1) Asset basis would increase by corporate taxable income and decrease by corporate losses. These incomes and losses might be from the ordinary course of business or from casual sales of property.

(2) Asset basis would decrease by non-deductible distributions or payments such as dividend payments, redemption payments, liquidation payments, federal income taxes, excess charitable donations, gifts paid, non-deductible interest, unreasonable compensation, and expenditures against public policy.

(3) Asset basis would increase with non-taxable receipts such as exempt income, gifts received, contributions to capital, or proceeds of stock sales.

Each of these, under the current statute, must be meticulously worked into the computation of earnings and profits.¹⁶¹ Each is *automatically* reflected, however, in the difference between the total adjusted basis of the assets and the total adjusted basis of the stock.

There is one remaining difference between the two adjusted basis totals that is not part of "earnings and profits" under current law. Take the stockholder who buys his shares from another stockholder, paying fair market value. Under current law, his basis is his cost, the fair market value of the shares, and his basis may differ from the selling stockholder's adjusted basis not only by all of the items listed above, but also by unrealized appreciation in the assets, goodwill (or "bad" will), and other unrecorded intangible assets (or unrecorded liabilities). Under the model, the new stockholder is taxed later only on distributions or sale proceeds that exceed his new basis. In a liquidation, redemption, or other distribution from the corporation, the new stockholder is taxed as on a dividend only on the difference between the adjusted basis of his stock given up and the adjusted basis of the property received. Later, when this property is sold, any remaining gain will be realized and taxed.

The old stockholder is taxed under the model on his unpaid dividends, measured by the difference between the old stockholder's share of the corporate asset basis and the old stockholder's stock basis given up (as if the corporation had been liquidated), and then on any remaining gain as if the old stockholder had sold the underlying assets to the new stockholder. Thus a sale of private stock is treated as identical to (1) a disposition of the stock by the old stockholder to the corporation in exchange for assets, (2) a sale of those assets, and (3) a contribution by the new stockholder for the stock.

The adjusted bases for the assets remaining in the corporation thus are increased by the sale,¹⁶² and the new stockholder's potential future dividends are reduced by the amount taxed to the old stockholder.¹⁶³ If the transfer of shares were by gift,

¹⁶¹ The adjustments to convert taxable income into earnings and profits are summarized in B. BITTKER & J. EUSTICE, *supra* note 151, ¶ 7.03.

¹⁶² A similar adjustment to basis is elective under the partnership provisions. See INT. REV. CODE OF 1954, §§ 734, 743, 754.

¹⁶³ Under current law, dividends are taxed to the recipient regardless of whether he purchased his stock the day before and thus paid an extra amount for these dividends and the selling stockholder thus paid extra capital gains taxes. See *United States v. Phellis*,

there would be no change in stock basis. The new stockholder would simply be substituted for the old in all respects. As to inheritances, basis would be increased as under current law.¹⁶⁴

Stock dividends would present no special problems under the model. The receipt of a private stock dividend would not be taxable for the same reasons that any private stock received would not be taxable. This rule would hold true regardless of whether the dividend consisted of stock identical to the stock on which it was paid or stock that increased the relative rights of the recipient at the expense of other stockholders. The present rules relating to taxable stock dividends¹⁶⁵ and the rules relating to "tainted" preferred stock dividends (gain on later sale of the dividend shares taxed at ordinary rates)¹⁶⁶ would no longer be necessary.

2. Public Stock and Public Stockholders

Payment of a dividend on public shares constitutes a transaction at the opposite pole from its private counterpart. The present statutory rules, of course, are the same for both. A public stock dividend, however, is no different from a sale of part of the value of the stock. The difference between the amount received and adjusted basis given up, therefore, should be taxed as capital gain. Once again, but for different reasons, the calculation of "earnings and profits" becomes unnecessary.

It will be argued in opposition that public stock dividends should be taxed as amounts received for the *use* of property and thus as ordinary income like rents, royalties, and interest received. This characterization, however, does not seem to reflect reality in the case of public stock. The public stockholder originally *sold* his invested assets to the corporation.¹⁶⁷ The dividend, like the liquidation payment discussed below, really constitutes a forced re-purchase of a portion of that stock and a corresponding liquidation of its underlying private rights and public stock market value.

257 U.S. 156, 169-72 (1921). Upon liquidation or redemption, unpaid dividends presently go untaxed permanently. INT. REV. CODE OF 1954, §§ 301, 331. The model results in taxing dividends only once, to the stockholder who was such during the time the dividends were earned by the corporation.

¹⁶⁴ INT. REV. CODE OF 1954, §§ 1014, 1015. These special basis sections would affect automatically the potential dividend as well as the potential gain on liquidation. Only the latter is affected under current law.

¹⁶⁵ INT. REV. CODE OF 1954, § 305(b).

¹⁶⁶ INT. REV. CODE OF 1954, § 306.

¹⁶⁷ See text accompanying notes 23-39 *supra*.

It will also be argued that public corporation dividends are true dividends because they are periodic, out of corporate earnings, and "intended" by corporate management to be a distribution of earnings. Suffice it to say that a substantial portion of gains on stock sales arise from intentionally retained earnings and thus also fit this description even though such portion is currently taxed at capital gains rates.¹⁶⁸

The public corporation also should recognize gain or loss if the dividend is paid in appreciated (or depreciated) property. The payment of the dividend, in effect, is in exchange for a portion of the value of the public shares that the corporation then offsets against the related private legal obligations formerly owed to its stockholders.

C. Complete Liquidations

The Internal Revenue Code treats most liquidations as taxable exchanges to the stockholders. Section 331, the general liquidation provision, calls for capital gain or loss to the stockholders measured by the difference between the fair market value of the assets received by each stockholder and the adjusted basis of his stock liquidated.¹⁶⁹ From the liquidating corporation's standpoint, the distribution is tax free.¹⁷⁰

1. Private Corporations and Private Stockholders

A distribution of assets by a private corporation to its stockholders essentially reverses the incorporation transaction. Just as a receipt of property by a private corporation should be tax free to both corporation and stockholder, so a distribution of prop-

¹⁶⁸ The argument that capital gains rates are necessary to avoid bunching up these gains into high tax brackets is also of questionable validity. Such bunching is offset by the valuable deferral of taxation until sale, and the bunching can be alleviated in many cases by income averaging. INT. REV. CODE OF 1954, §§ 1301-04. An extended discussion of the theoretical difference between dividends and capital gains, however, is not possible here. For some interesting variations, see Andrews, "Out of Its Earnings and Profits": *Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403 (1956).

¹⁶⁹ If the corporation being liquidated is an 80%-owned subsidiary of another corporation, then the two corporations in effect are treated as one and a liquidation of the subsidiary into the parent is tax free to the parent corporation. INT. REV. CODE OF 1954, § 332. Individual stockholders may elect a tax-free liquidation if individual shareholders with 80% of the stock held by that class approve, except that unpaid dividends are taxed at ordinary rates. Any remaining gain is taxed only to the extent that cash and marketable securities are distributed. INT. REV. CODE OF 1954, § 333. Corporate stockholders none of whom own more than 50% of the liquidating corporation's stock may make a similar election with 80% approval. *Id.*

¹⁷⁰ INT. REV. CODE OF 1954, § 336. For non-liquidating distributions, see INT. REV. CODE OF 1954, § 311.

erty to the stockholder should be tax free to both.¹⁷¹ The basis of the assets distributed should be the same as their basis in the hands of the corporation so that any unrealized gain or loss in those assets is preserved. This gain or loss will then be realized in the future when the assets are sold.¹⁷²

So much is clear with respect to a corporation with only one stockholder. If the corporation has more than one stockholder, however, and if each stockholder does not receive back the exact property he put in, it could be argued that there has been a completed exchange. In the example used earlier, *A* had originally transferred some real estate to the corporation, and *B* had transferred some equipment of equal value. Assume that upon liquidation they each received one-half of the real estate and one-half of the equipment. Why should *A* not be treated as having exchanged one-half of his real estate for one-half of *B*'s equipment and vice versa? The answer is that the liquidation, *taken by itself*, is no more than a like-kind exchange. The private stock being liquidated is really the alter ego of the assets received. The liquidation is a mere change in form and should be tax free.

Why, though, should the liquidation be taken by itself? Why should it not be combined with the previous incorporation transfer (or stock purchase, if the stockholder received his shares by purchase) and seen as an indirect exchange of assets? The answer is the same as it is for incorporation transfers: The "profit motive" would override and intervene between the incorporation and the subsequent liquidation.¹⁷³ The profit motive would operate to separate the two transactions so that the liquidation transaction should be treated as a wholly separate transaction. Just as the mere ceasing to do business by a corporation prior to its liquidation is not a taxable event, so the elimination of the corporate shell should not be deemed a taxable event. Liquidation of a private corporation would be treated as a tax-free transaction similar to the present one-month elective provisions

¹⁷¹ The model thus comes very close to mandating the § 333 approach for private corporations although it eliminates the cash and marketable securities rule.

¹⁷² The § 333 election, by contrast, substitutes the basis that the former stockholders had in their stock as a new basis for the assets received in liquidation. INT. REV. CODE OF 1954, § 334(c). This basis is then prorated among the assets according to their relative fair market values. Treas. Reg. § 1.334-2 (1955). This basis rule is rendered unnecessary under the model by a different concept for measuring dividends. See text accompanying notes 39-41 *supra*.

¹⁷³ See text accompanying note 130 *supra*.

for corporate liquidations¹⁷⁴ or the partnership liquidation provisions.¹⁷⁵

There might be some untaxed potential dividends, of course, at the time of liquidation. These should be taxed to the stockholders at the time of liquidation, not because the liquidation represented a true realization, but because the corporation was going out of existence. The liquidation would be the last practical time to collect the dividend tax.¹⁷⁶ The extra gain, the portion not yet realized by the corporation, would thus be the portion not taxed.

It could be argued that tax-free treatment for this extra gain should be reserved only for pro-rata asset distributions. To the extent that a distribution was not pro rata the additional unrealized gain could be taxed. Section 751 adopts this approach for distributions of certain inventory and accounts receivable by partnerships.¹⁷⁷ The thought apparently is that the non-pro-rata portion was in effect received in an exchange with the other partners.

The model, however, does not draw the tax-free line at pro-rata distributions. It does not adopt the section 751 approach. There would seem to be no special magic in pro-rata shares unless one assumes either that the same pro-rata shares were put into the corporation originally or that the stockholders really owned undivided pro-rata shares of each asset immediately before the distribution.¹⁷⁸ The former possibility assumes a highly unlikely set of facts. As to the latter, the stockholders usually would be entitled to pro-rata shares only if they did not agree otherwise and if the assets were not sold first. Prior to actual distribution, the private stockholders merely own in-

¹⁷⁴ INT. REV. CODE OF 1954, § 333. See notes 168 & 172 *supra*.

¹⁷⁵ INT. REV. CODE OF 1954, § 732. Generally, a partnership liquidation is taxable only to the extent that cash exceeds any basis remaining for the partner's interest after deducting the basis of all non-cash distributions. The theory behind the partnership rules, however, differs from that of the model. Whereas the model introduces the "profit motive" between two transactions that together would otherwise constitute a taxable exchange in order to produce a situation where no "property" is transferred, the basis for the partnership rules is that the partnership is not a separate entity. See INT. REV. CODE OF 1954, § 701.

¹⁷⁶ For a discussion of dividends, see text accompanying notes 138-47 *supra*.

¹⁷⁷ Under § 751, distributions of certain receivables and inventory retain their ordinary income character, and, to the extent not distributed prorata, are taxable in a partnership liquidation.

¹⁷⁸ To the extent that § 751 is based on the premise that because the partnership is not a separate entity for tax purposes, the partners are pro-rata owners, it is inapplicable in the corporate context.

tangible rights in the nature of receivables which are not sufficient to give them specific rights to any of the underlying assets.¹⁷⁹

2. Public Corporations and Public Stockholders

Liquidations of public corporations consist of completed exchanges of the public stock for assets of the corporation. Such exchanges should result in taxable capital gain or loss to the stockholder to the extent that the fair market value of the property distributed exceeds his stock's adjusted basis. This is the current general rule for all stock.¹⁸⁰

From the standpoint of the public corporation, a complete liquidation would result in the destruction of its public stock market and thus of the intangible asset that has been referred to as its extra stock market value. Because the corporation had no basis (no cost) for that intangible asset, however, its destruction would not result in a deductible loss. The consideration received in complete liquidation of a public corporation would consist simply of the discharge of its private legal obligation to distribute all remaining assets to its stockholders. Because the corporation would still be public, gain or loss would be recognized in such distribution to the extent that each asset had a basis other than its fair market value.

D. *Redemptions and Partial Liquidations*

The present statute treats stock redemptions and partial liquidations as sales of the shares redeemed.¹⁸¹ The result is usually capital gain or loss to the stockholder. Usually, no gain or loss is recognized by the redeeming corporation.¹⁸² No dividends are deemed distributed in a true redemption or partial liquidation.¹⁸³

The model would treat stock redemptions, partial liquidations, and dividend payments as identical transactions. Accordingly, redemptions and partial liquidations of private shares

¹⁷⁹ Not requiring pro-rata liquidations would be consistent with § 351, which does not require pro-rata distributions of each type of stock and security issued to the stockholders. Such a pro-rata requirement was eliminated as a trap for the unwary in 1954, although it was a part of the 1939 Code and prior acts. See S. REP. NO. 1622, 83rd Cong., 2d Sess. 264 (1954).

¹⁸⁰ INT. REV. CODE OF 1954, § 331.

¹⁸¹ INT. REV. CODE OF 1954, §§ 302, 346.

¹⁸² INT. REV. CODE OF 1954, § 311.

¹⁸³ INT. REV. CODE OF 1954, §§ 301, 302, 331.

would be tax free except for the dividend portion, which would be taxed at ordinary rates. Gain would be measured by the difference between the asset basis received and the stock basis given up. A redemption of private shares would not result in taxation of potential gain that had not already been realized at the corporate level. The present "safe harbors" in section 302 of a "substantially disproportionate" redemption or a "complete termination" of the stockholder's interest would be unnecessary under the model; all redemptions of private stock would be treated as true dividends to the extent of the difference between the adjusted basis received and that given up. Any remaining gain would be deferred.

Redemptions of public shares under the model would be taxed as true sales, just as under the present law. The gain would be measured by the fair market value received less the adjusted basis given up. From the public corporation's standpoint, redemptions and partial liquidations should also be treated as sales or exchanges. Gain or loss thus would be recognized by the public corporation to the extent of the difference between the fair market value of the stock being liquidated or redeemed and the adjusted basis of the corporate property given in exchange.

E. Sales

Under the present statute, a sale of stock is treated as a taxable sale of a capital asset regardless of whether any or all of the gain can be traced to unpaid dividends and regardless of the various types of underlying corporate assets.¹⁸⁴ This treatment is proper in the case of a public corporation because it reflects the reality that public stock is a true separate asset. For private stock sales, however, the model would make two changes: Unpaid dividends would be taxed to the selling stockholder as ordinary income, and any remaining gain would be taxed at ordinary or capital rates depending upon the nature of the underlying corporate property.

The practical reason for taxing unpaid dividends upon private stock dispositions has already been explained.¹⁸⁵ The old stockholder has been allowed a deferral up to the point of disposition, and the disposition represents the last chance to tax him. Moreover, by the disposition, he has abandoned his corpo-

¹⁸⁴ See INT. REV. CODE OF 1954, § 1221.

¹⁸⁵ For a discussion of dividends, see text accompanying notes 159-68 *supra*.

rate "profit motive" and has thus, in effect, reversed his election to substitute present corporate tax rates for present individual tax rates. Whether the disposition is by redemption, liquidation, or sale should make no difference.

On the other hand, a stock sale goes one step further. Although in a corporate liquidation or redemption the intervention of the "profit motive" serves to separate the original placing of assets in the corporation from such liquidation,¹⁸⁶ the same cannot be said of a stock sale. From the selling stockholder's standpoint, a sale of private stock essentially involves a liquidation or redemption distribution *plus* a taxable sale of the assets received in the distribution. These two steps do not actually take place, of course, but that is the effect of a private stock sale. No profit motive intervenes to separate and take precedence over the disposition of the old stock (that is, the old assets) from the receipt of new assets. The sale is thus not a mere change over time in the form of the old assets; it is a true exchange of old assets for new assets.¹⁸⁷

F. *Reorganizations*

1. Mergers

a. *A Private Merger*

A merger of one corporation into another may be either of two of the six kinds of reorganizations.¹⁸⁸ Under this heading, we shall discuss the merger of two private corporations. It could be a "statutory" merger effected pursuant to the merger requirements of a state corporation law (section 368(a)(1)(A)), or a "practical" merger pursuant to which one corporation acquires substantially all of the assets of another in exchange for the acquirer's voting stock (section 368(a)(1)(C)). The statutory

¹⁸⁶ See text accompanying notes 173-74 *supra*.

¹⁸⁷ The approach to private stock sales taken in the model would introduce a complication not now present in the law. It would be necessary for the selling stockholder to prorate the amount received among the various assets deemed sold to calculate the amount and type of gain or loss on each asset. This is no more than what is presently required for the sale of an unincorporated business. *Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). Because the purchase price of private stock usually is calculated by reference to the assets, the necessary information probably would be available in most cases. The partnership provisions utilize an intermediate approach. The sale of a partnership interest is treated as the sale of a capital asset (§ 741) except for § 751 assets ("substantially appreciated inventory" and "unrealized receivables," the latter including depreciation recapture under §§ 1245 & 1250), which gain is treated as ordinary income.

¹⁸⁸ INT. REV. CODE OF 1954, § 368(a)(1).

merger is often referred to as an "A reorganization," and the practical merger as a "C reorganization."

Sections 354, 361, and 1032, taken together, permit tax free (1) the exchange of the corporate assets of the merged corporation for voting stock of the surviving corporation, and (2) the exchange of such voting stock of the surviving corporation for the stock of the merged corporation (the latter is then cancelled). In both cases, the exchange must take place pursuant to a plan of reorganization. The basis of the assets of the merged corporation carries over and remains the same in the surviving corporation.¹⁸⁹ The basis of the merged corporation's stock (which is given up and cancelled) is transferred over and used as the basis for the voting stock of the surviving corporation which is received in exchange.¹⁹⁰ These are the same exchange and basis rules that have been discussed above in connection with section 351 incorporations.¹⁹¹

Just as in the case of section 351, from the standpoint of the private stockholder who remains such after the merger (that is, assuming that both corporations are private corporations), the present statute, if anything, is too strict. For example, why should it be necessary, in a C reorganization, to transfer "substantially all" of the corporate assets in order to receive tax-free treatment?¹⁹² This requirement presumably was intended to separate mergers of whole businesses from constructive dividends or from mere purchases of assets by one corporation from another.¹⁹³ Still, private stock, as we have seen, is not property that is separate from the underlying assets. The merger transaction is exactly the same as if the merged corporation had contributed assets to the surviving corporation in exchange for private stock in a section 351 transaction. The receipt of the private stock should be tax free.¹⁹⁴ The subsequent distribution

¹⁸⁹ INT. REV. CODE OF 1954, § 362(b).

¹⁹⁰ INT. REV. CODE OF 1954, § 358.

¹⁹¹ The A reorganization also includes a "consolidation" pursuant to which both old corporations transfer their assets to a new corporation, and the stock of the new is exchanged for the shares held by the stockholders of both old corporations. Such a consolidation also would qualify as a § 351 transfer.

¹⁹² INT. REV. CODE OF 1954, § 368(a)(1)(C).

¹⁹³ "Substantially all," for ruling purposes, means at least 70% of the gross assets and 90% of the net assets. Rev. Proc. 74-26, 1974-2 CUM. BULL. 479. A "constructive dividend" would result from retaining in the old corporation the dividend assets and then later attempting to liquidate them out at capital gains rates. See *Gregory v. Helvering*, 293 U.S. 465 (1935).

¹⁹⁴ See text accompanying notes 129-35 *supra*.

of the surviving corporation's stock to the stockholders of the merged corporation, then, is like any other receipt of private stock. It, too, should be tax free. In other words, there is no special significance about a merger as a "reorganization." The same transactions by any name should be tax free.

Furthermore, why should the "solely for voting stock" requirement be retained for C reorganizations?¹⁹⁵ The function of this provision is to ensure a degree of continuity of interest on the part of the stockholders of the merged entity.¹⁹⁶ In an A reorganization, the courts and the Internal Revenue Service have developed a similar continuity of interest doctrine.¹⁹⁷ Tax-free treatment is denied if the merger results in a cashing-in of too much of the former assets or stock of the merged corporation or its stockholders. To the extent that private stock is received, however, the continuity of interest requirement is not necessary. All receipts of private stock should be tax free, whether or not connected with a merger, because they are not receipts of "separate property."

The only remaining difference between a private merger and a private exchange of unincorporated assets for stock is that in the former, the stockholder of the merged corporation might start out with a basis for his old stock different from the basis the merged corporation had in the underlying assets. The stockholder, for example, might have purchased his stock from someone else, or the corporation might have suffered losses or might not have distributed all its earnings. In such a case, under the present statute,¹⁹⁸ the basis of the old stock becomes the basis of the new stock, and the surviving corporation inherits a carryover of the undistributed earnings and profits or losses.

The model takes a somewhat different approach. As with dividends, "earnings and profits," the traditional measure of dividends, is discarded. Therefore, no earnings and profits must be carried over from the merged corporation to the sur-

¹⁹⁵ The C reorganization limits the consideration paid by the surviving corporation to "solely . . . voting stock." INT. REV. CODE OF 1954, § 368(a)(1)(C). Section 368(a)(2)(B) then relaxes this requirement somewhat by permitting the surviving corporation to assume the liabilities of the other corporation and to pay cash or other property, up to 20% of the value of the gross assets, less the liabilities assumed.

¹⁹⁶ Treas. Reg. § 1.368-1(b), (c) (1955).

¹⁹⁷ See *Letulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

¹⁹⁸ INT. REV. CODE OF 1954, §§ 358 (basis of old stock transfers to new stock), 381 (carryover of tax attributes), 382 (limitation on carryover of net operating losses).

viving corporation.¹⁹⁹ Upon a disposition of private stock to the issuing corporation, whether in connection with receipt of a dividend, redemption, liquidation, or reorganization, the total taxable gain or loss to the stockholder will be measured by the difference between the adjusted basis of the property received and the adjusted basis of the stock given up. Earnings and profits will play no part in this computation.

To the extent that private stock is *received*, however, no "separate property" is received, so the basis, under the model, will stay the same. Although the theory is different, the model would produce the same tax result at this point as the present statute. The potential dividend for each stockholder will then continue to be the difference between the two bases.

An example may help to clarify these rules. Assume that private corporations *A* and *B* have balance sheets as follows:

<i>A</i> CORPORATION				<i>B</i> CORPORATION			
Assets	\$100	Stock	\$ 10	Assets	\$ 50	Stock	\$ 20
		Earnings	<u>90</u>			Earnings	<u>30</u>
Total	\$100	Total	\$100	Total	\$ 50	Total	\$ 50

If *B* merged into *A*, the combined balance sheet would look like this:

<i>A(B)</i> CORPORATION			
Assets	\$150	Stock ($\frac{2}{3}$ to <i>A</i> stockholders)	40
		Stock ($\frac{1}{3}$ to <i>B</i> stockholders)	20
		Earnings (of <i>A</i> corporation)	<u>90</u>
Total	\$150	Total	\$150

Remember that earnings are irrelevant under the model. If the personal adjusted bases to the stockholders of *A* and *B* for their stock were, say \$15 and \$45, respectively, both before and after the merger, then the potential maximum dividend income would be \$85 to the *A* stockholders and \$5 to the *B* stockholders both before and after the merger. Assuming a complete liquidation, for example, two-thirds of the assets would go to the *A* stockholders and one-third to the *B* stockholders, and the dividend would be calculated as follows:

¹⁹⁹ This would be true only to the extent that such carryovers presently affect stock transactions. For the internal corporate purpose of offsetting past losses against future corporate profits, the limitations in § 382 could be continued.

DIVIDEND INCOME UPON LIQUIDATION OF A(B) CORPORATION

	A Stockholders	B Stockholders
Adjusted Basis of Assets Received	\$100 (2/3rds)	\$50 (1/3rd)
Less Adjusted Basis of Stock	<u>15</u>	<u>45</u>
Dividend	<u>\$ 85</u>	<u>\$ 5</u>

Because every disposition under the model statute, therefore, would either be (1) tax free (private stock-for-private stock, or gift or inheritance with a carryover of basis, or (2) taxable (with the dividend portion taxed as ordinary income), there would be no need to use earnings and profits to preserve untaxed dividends for a new owner. That A(B) Corporation ends up with only \$90 of earnings would have no tax significance.

b. *A Public Merger*

Consider next a merger between two public corporations. New public stock is issued for the old public stock or the assets of another public corporation. The exchange should be taxable on both sides. The surviving corporation issuing the new public stock should be taxed as in the discussion above on incorporations. The gain should be taxed at capital gains rates.

Because the merged corporation was a public corporation, however, the gain should be recorded by the surviving corporation as a separate intangible asset and not as an increase in the basis of assets purchased.²⁰⁰ The various assets purchased should be recorded at their old adjusted bases. That way it would not matter which corporation merged into which. The resulting gain and asset bases would thus be the same:

X CORP.			Y CORP.		
Assets	\$10,000*	Stock of X	\$10,000	Assets	\$14,000*
				Stock of Y	\$14,000
*Fair market value of Assets = \$14,000			*Fair market value of Assets = \$14,000		

Regardless of whether X merges into Y, or Y merges into X, the result would be the same:

²⁰⁰ This "intangible asset" would be the stock market value of the merged corporation and the amount paid for it should be equal to the excess of the consideration paid over the total adjusted basis of the other assets. See text accompanying notes 138-58 *supra*.

XY CORPORATION			
Assets of X	\$10,000	Stock of X	\$12,000
Assets of Y	\$14,000	Stock of Y	\$12,000
Intangible			
Asset	\$ <u>2,000</u>	Gain	\$ <u>2,000</u>
Total	\$ <u>26,000</u>	Total	\$ <u>26,000</u>

Regardless of which corporation survived and which merged, the \$2,000 gain would be the fair market value of the assets received (\$14,000) less the cost of the new stock issued (one-half of the total adjusted bases for all the assets, \$12,000).

At the stockholder level, nothing happens when the two underlying public corporations merge. The corporations are separate entities from their stockholders. The stock may experience depreciation or appreciation in value on the stock market, but that is all. No exchange has taken place, and, therefore, no gain or loss should be recognized. Although newly issued stock of the surviving corporation probably will be issued directly to the stockholders of the merged corporation or distributed to them upon the liquidation of their old corporation, this is not a significant exchange. It is an exchange of one identical share of stock for another and should be ignored for tax purposes. Upon the merging of the assets, the stocks of both corporations *automatically* become stock of the surviving corporation; a simultaneous or subsequent exchange of pieces of paper with the name of the surviving corporation in place of the name of the merged corporation is of no consequence. The model so provides.

c. Public-Private Merger

Next we must consider the proper treatment of a merger of a private corporation into a public corporation. (The reverse also is theoretically possible, but the end result would be the same; the surviving corporation would still end up as a public corporation.)

The issuance of the public stock, under the model, would be a taxable event.²⁰¹ The merged private corporation would be treated as if its assets were owned directly by its stockholders. Accordingly, gain or loss would be recognized to the same extent as if the stockholders had exchanged those assets directly for public stock.

²⁰¹ See text accompanying notes 136, 138-58 *supra*.

The only question would be what to do with the undistributed earnings. If they carried over, then the deferral of gain would continue; if not, then the private stockholders would have to pay tax on their gain because the reorganization would be identical to an asset sale followed by a liquidation. Sale treatment would seem closer to reality. From the private corporation's standpoint, the reorganization is a sell-out followed by a distribution of the proceeds, the public stock, in liquidation. The proper treatment of undistributed earnings upon a liquidation of a private corporation would be to tax them to the shareholders at ordinary rates.²⁰² This amount would be measured by the difference between the adjusted basis of the assets distributed (the public stock) and the adjusted basis that the stockholders had in their private shares.²⁰³

2. Stock Acquisitions

The third of the acquisition-type reorganizations, the section 368(a)(1)(B) ("B") reorganization, differs from the A and C reorganizations in that the acquiring corporation must acquire the stock of the other corporation, rather than its assets, through direct individual dealings resulting in an exchange of stock with each of the stockholders of the acquired corporation. At least eighty percent of the acquired corporation's stock must end up being owned by the acquiring corporation for the stock-for-stock exchange to qualify as tax free.²⁰⁴ As a result, the acquiring corporation becomes the parent corporation and the acquired corporation becomes its at-least-eighty-percent subsidiary.

To the extent that the acquired corporation is a private corporation, the tax treatment should be the same as in an A or C reorganization. The private stock given up should be equated with an acquisition of the underlying corporate assets from the standpoints of both the acquiring corporation and the selling stockholders.²⁰⁵ As a result, if the acquiring corporation is a

²⁰² Text accompanying notes 161-64, 184-87 *supra*.

²⁰³ Alternatively, it could be provided that only the gain corresponding to the difference in adjusted bases *before* the merger should be a dividend, because the two (merger and liquidation) were steps of a single plan. This same alternative could be preserved for corporate sales followed by liquidations outside the merger area. The result would be similar to present § 337.

²⁰⁴ INT. REV. CODE OF 1954, § 368(a)(1)(B). The 80% test is set forth in § 368(c). As with § 351 transfers, its purpose is to preserve "continuity of interest." See note 197 *supra*.

²⁰⁵ The stock-for-stock exchange collapses what is in theory two transactions: the private stockholder's exchange of his stock for the underlying assets, and the exchange of the assets for the acquiring corporation's stock.

public corporation, its issuance of public shares would be taxable on both sides. If the acquiring corporation is a private corporation, however, then it should not be taxable to either side because only private stock would be changing hands.

If the acquired corporation is a public corporation, the focus must shift from the corporate to the stockholder level. After all, the exchanges are being undertaken individually with each of the public stockholders and should be taxed on their level. The resulting gain would be taxed at capital gains rates, just as in any other disposition of public stock.

The acquiring corporation should be taxed as in the A and C reorganizations. It should make no difference that the acquiring corporation is receiving stock rather than assets. The resulting subsidiary (the corporation so acquired) probably would become a private corporation, and its subsequent liquidation would follow the rules for private corporation liquidations outlined earlier.

3. Divisions

The section 368(a)(1)(D) ("D") reorganization is most often used to divide a single corporation into two corporations or to distribute the stock of an existing subsidiary to the stockholders of the parent corporation.²⁰⁶ The opportunity for abuse in a D reorganization lies in its similarity to the payment of a dividend. If excess cash were split off into a new corporation, for example, the resulting stock could be distributed tax free, and the stockholders presumably could then liquidate or sell the stock at capital gains rates.²⁰⁷

Under the model, a private corporation could be liquidated or its stock sold only by taxing previously untaxed dividends to the extent of the shares liquidated. The tax would be at ordinary rates. Thus, although a spin-off could be accomplished, a later liquidation and sale would result in ordinary income. If the resulting corporation were a true public corporation, however,

²⁰⁶ INT. REV. CODE OF 1954, § 368(a)(1)(D). The D reorganization consists of a transfer of some or all of a corporation's assets to another corporation if immediately thereafter the transferor controls the transferee. To this extent the D reorganization resembles a § 351 transfer. The D reorganization, however, also requires the transferor to distribute the stock of the transferee to its (the transferor's) shareholders, which distribution is tax-free if the conditions of § 355 are met.

²⁰⁷ See *Gregory v. Helvering*, 293 U.S. 465 (1935). The "business purpose" test introduced in *Gregory* has now been formalized by the "five-year active trade or business" requirement under § 355(b)(2).

then capital gains would be appropriate; the spin-off distribution would not be the equivalent of a dividend, but neither would it be tax free.

The only question concerns the proper treatment of a stock distribution pursuant to a D reorganization *prior* to the sale of the stock or the liquidation of the corporation. If private stock is distributed, no tax consequences should follow because the underlying assets were already owned indirectly anyway. The private stock so distributed would not be "separate property." The result would be no different from a partial liquidation.

If the corporation is public, then the distribution of public stock should be considered a taxable event similar to any other public stock distribution. What difference should it make to the public stockholders that the reason for the distribution is that the underlying corporation has been split into two corporations? Assuming that both resulting corporations are public corporations, it should make no difference at all.

4. Single Corporation Reorganizations

The section 368(a)(1)(E) and (F) ("E" and "F") reorganizations generally apply to a single corporation that recapitalizes or experiences a mere change in form (such as reincorporation in a different state).²⁰⁸

In the case of a public corporation, a mere exchange of, say, old common stock for new common stock would be a true like-kind exchange and ought to be tax free. This result is achieved by present section 1036 and is continued in the model.

Private E and F reorganizations should also be tax-free, just as were the original "organizations" under section 351. The model accomplishes this result because only private stock is being exchanged.

G. Conclusion

The foregoing transactional analysis was divided into six topics so that it would correspond to the present transactional arrangement of the Internal Revenue Code. This treatment, however, makes the result seem more complicated than it really is. In general, there are only two functional distinctions under each of private stock and public stock: stock receipts and stock dispositions. Stock receipts include stock received pursuant to

²⁰⁸ INT. REV. CODE OF 1954, §§ 368(a)(1)(E),(F).

incorporations, reorganizations, stock dividends, and stock purchases. Stock dispositions include stock disposed of pursuant to liquidations, redemptions, dividends, reorganizations, and sales.

Private stock received from the issuing corporation for transfers of assets or services to the issuing corporation should not be deemed a taxable receipt of property. A disposition of private stock to the issuing corporation should be treated as a non-taxable transaction. A sale of private stock to a third person, however, really consists of a liquidation followed by a taxable sale of the underlying assets by a former stockholder. The purchaser is buying the assets; he is looking strictly to their value regardless of whether, in form, the transaction is cast as a stock sale.

Receipts of public stock should be treated as receipts of any other separate property. The nature of any gain as capital gain or ordinary income would then be determined by the nature of what was given in exchange. Dispositions of public stock likewise should be treated as dispositions of separate property. Even original issuances of public stock should be deemed taxable dispositions. In such a case the gain would be measured by the fair market value of any property received less the related portion of the adjusted basis of the underlying corporate assets. All dispositions of public stock should be taxed at capital gains rates if the public stock disposed of is a capital asset in the hands of the person disposing of it.

V. A MODEL FOR THE CORPORATE INCOME TAX

Section 1. Private Stock.

(a) *Receipts from Issuing Corporation.*

(1) A receipt of private stock from the issuing corporation shall not be treated as a taxable receipt of property. This subsection shall apply to any such receipt of private stock including a receipt pursuant to

- (A) an incorporation transfer,
- (B) a stock dividend, or
- (C) a reorganization.

(2) Accordingly, no gain or loss shall be recognized by the person receiving such stock, and the adjusted basis of such stock

to the person receiving it shall be the adjusted basis of the property, if any, given in exchange for the stock.

(3) No gain or loss shall be recognized by the issuing corporation, and the adjusted basis of any property received in exchange by the issuing corporation shall be the adjusted basis of such property to the transferor-stockholder.

(b) *Dispositions to Issuing Corporation.*

(1) A disposition of private stock to the issuing corporation shall not be treated as a taxable disposition of property. This subsection shall apply to any such disposition of private stock, including a disposition pursuant to

- (A) a partial or complete liquidation,
- (B) a partial or complete redemption,
- (C) a dividend paid in property, or
- (D) a reorganization.

(2) Accordingly, no gain or loss shall be recognized by the stockholder disposing of the stock, and the adjusted basis of any property received by such person in exchange for such stock shall be the same as the adjusted basis of such property to the issuing corporation.

(3) Notwithstanding any other provision of this section, upon a disposition of private stock, the person disposing of such stock shall recognize, as a dividend, his corresponding share of previously undistributed corporate earnings. Such share shall be measured by the difference between

- (A) the adjusted basis of any property received in exchange, and
- (B) the adjusted basis (as defined in section 3(c)) of the amount of stock given up.

For this purpose, the amount of stock given up shall be measured by the percentage decline in such person's stock ownership.

(c) *Other Receipts and Dispositions.*

(1) A sale or other disposition of private stock (other than to the issuing corporation) shall be treated as

- (A) a disposition of such stock to the corporation in exchange for a corresponding portion of the underlying assets, and
- (B) a sale or other disposition of such assets.

(2) A receipt of private stock (other than from the issuing corporation) shall be treated as

- (A) a receipt of such assets, and
- (B) a disposition of such assets to the corporation in exchange for such stock.

(3) Notwithstanding any other provision of this section, an exchange of private stock for private stock shall not be a disposition and therefore shall not be taxable, and the basis of the private stock given up shall become the basis of the private stock received.

Section 2. Public Stock.

(a) *Receipts from Issuing Corporation.*

(1) a receipt of public stock from the issuing corporation shall be treated as a receipt of property. This subsection shall apply to any such receipt including a receipt pursuant to

- (A) an incorporation transfer,
- (B) a stock dividend, or
- (C) a reorganization.

(2) Accordingly, gain or loss shall be recognized by the stockholder receiving such public stock measured by the difference between

- (A) the fair market value of the public stock received, and
- (B) the adjusted basis of any property given in exchange.

For this purpose, the amount of public stock received shall be measured by the percentage increase in such stockholder's stock ownership. The adjusted basis of the public stock received shall be its fair market value.

(3) Gain shall also be recognized by the public corporation issuing such public stock measured by the difference between

- (A) the fair market value of any property received, and
- (B) the adjusted basis of the corresponding pro-rata portion of the net assets of the issuing corporation.

(b) *Dispositions to Issuing Corporation.*

(1) A disposition of public stock to the issuing corporation shall be treated as a taxable sale or exchange of property. This

subsection shall apply to any such disposition of public stock, including a disposition pursuant to

- (A) a partial or complete liquidation,
- (B) a partial or complete redemption,
- (C) a dividend paid in property, or
- (D) a reorganization.

(2) Accordingly, gain or loss shall be recognized by the stockholder disposing of such public stock measured by the difference between

- (A) the fair market value of the property received, and
- (B) the adjusted basis (as defined in section 3(c)) of the amount of public stock given in exchange.

For this purpose, the amount of public stock given in exchange shall be measured by the percentage decline in such stockholder's stock ownership.

(c) *Other Receipts and Dispositions.*

(1) A sale or other disposition of public stock (other than to the issuing corporation) shall be treated as a sale or other disposition of separate property.

(2) A receipt of public stock (other than from the issuing corporation) shall be treated as a receipt of separate property.

(3) Notwithstanding any other provision of this section, an exchange of identical public shares shall not be taxable, and the basis of the stock given up shall become the basis of the stock received.

Section 3. Definitions; Identical Shares.

(a) *Public Stock.*

(1) Primary Characteristic. The term "public stock" shall mean stock which is readily tradable in an established market.

(2) Secondary Characteristics. That no single stockholder possesses actual control over the corporation and that the stock does not directly reflect the same benefits and risks as relate to the underlying corporate assets may be considered persuasive evidence that the stock is "public stock" but only if the existence of the primary characteristic is in doubt.

(b) *Private Stock.*

Stock which is not "public stock" is "private stock."

(c) *Identical Shares.*

The adjusted basis of each identical share of stock owned by the same person shall be the average of the adjusted bases of all such shares owned by such person.