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THE IMPACT OF SECTION 306 UPON CONVERTIBLE PREFERRED STOCK ISSUED IN A CORPORATE REORGANIZATION *

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Convertible preferred stock¹ has become increasingly popular in the world of merger and acquisition finance. A *New York Times* article dated April 17, 1966² lists three proposed reorganizations in which convertible preferred stock was to be issued,³ and two consummated reorganizations in which such convertible shares had been issued.⁴ Eleven days later, the *Times* indicated that under the terms of the proposed International Telephone and Telegraph Corporation-American Broadcasting Company merger, I.T.T. would issue both common and convertible preferred shares in exchange for A.B.C. com-

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¹ This article will be concerned with preferred stock convertible at the option of the shareholders. See 4 Z. CAVITCH, *BUSINESS ORGANIZATIONS WITH TAX PLANNING*, § 92.01(1), at 1131 n.1 (1964) [hereinafter cited as CAVITCH].

² Vartan, *A Merger Factor: Convertibles*, N.Y. Times, April 17, 1966, § 3, at 2, col. 3.

³ The proposed reorganizations cited by the *Times* involved the following corporations: (a) Gustin-Bacon Manufacturing Company and Certain-teed Products Corporation; (b) KVP Sutherland Paper Company and Brown Company; and (c) Filmways, Incorporated and Seven Arts Productions, Limited. KVP Sutherland merged into Brown on May 12, 1966; Gustin-Bacon merged into Certain-teed on July 1, 1966.

⁴ Convertibles were issued by Gulf and Western Industries when acquiring New Jersey Zinc Company, and by Union Oil Company of California when acquiring Pure Oil Company.

mon stock.⁵ And in June of 1967, the *Wall Street Journal* carried at least four articles involving mergers or acquisitions in which convertible preferred would play a key role.⁶

Convertible preferred shares have become popular as a vehicle for mergers and acquisitions for several non-tax-oriented business reasons. Despite the fact that a convertible issue may tend to reduce the price of outstanding common stock, an acquiring corporation will favor a convertible over a regular preferred issue because the conversion privilege will tend to enhance the marketability, if not the market value, of the issue.⁷ This enhanced marketability may determine whether or not a desirable acquisition will occur. At the same time, an acquiring corporation may favor a convertible preferred over a common stock issue for two reasons. First, initial issuance of additional common stock might unduly dilute the equity position of common shareholders of the acquiring corporation;⁸ second, common stock might be unattractive to the shareholders of the corporation to be acquired simply because of its non-preferred status. Preferred stock is apt to be more attractive to the investor, particularly in periods of market decline.

Under such circumstances, convertible preferred will generally appear to offer the best of both worlds (given a favorable exchange rate). During critical periods, the shareholder may retain his convertible preferred stock and share in the distribution of available corporate earnings and profits with the assurance that his convertible stock will be more readily marketable than ordinary preferred. During

⁵ N.Y. Times, April 28, 1966, at 61, col. 3.

⁶ Wall St. J., June 6, 1967 at 8, col. 2 (Kern County Land Co. into Tenneco, Inc.); Wall St. J., June 12, 1967, at 8, col. 2 (Marquardt Corp. into Automation Industries, Inc.); Wall St. J., June 15, 1967, at 9, col. 1 (Kalamazoo Paper Co. into Georgia-Pacific Corp.); Wall St. J., June 27, 1967, at 28, col. 1 (F. M. Stamper Co. and General Mills, Inc.).

⁷ 4 CAVITCH § 92.01(1), at 1132 n.4. But see B. GRAHAM, D. DODD & S. COTTE, SECURITY ANALYSIS 603 (1962). [hereinafter cited as GRAHAM]. The authors suggest that an ordinary preferred issue will have a higher market value than a convertible issue during periods of decline. 1946-47 figures cited by them would appear to support the conclusion. The following table is taken from GRAHAM at 603:

PRICE RECORD OF NEW PREFERRED-STOCK ISSUES OFFERED IN 1946

Price change from issue price to low up to July 1947	"Straight issues" 7 issues	Convertible and participating issues 0 issues
No decline		
Declined:		
0—9.99 per cent	16	2
10—19.99 per cent	11	6
20—39.99 per cent	3	22
40 per cent or more	0	12
Totals	37	42
Average decline	About 9%	About 30%

⁸ Alexander & Landis, *Bail-Outs and the Internal Revenue Code of 1954*, 65 YALE L.J. 909, 924 (1956) [hereinafter cited as Alexander & Landis, *Bail-Outs*].

upswings, the shareholder may convert, thereby sharing in the growth of the company.⁹

Despite these non-tax oriented business factors which recommend convertible preferred stock as a vehicle for mergers and acquisitions, a proposed reorganization involving the issuance of convertible preferred stock will undoubtedly fail if the shareholders of the corporation to be acquired believe that the convertible preferred stock will constitute and be taxed upon disposition as section 306 stock.¹⁰ In those cases in which an acquiring corporation has issued convertible preferred stock, the section 306 problem has undoubtedly been disposed of in a manner favorable to shareholders of the acquired enterprise, either through the written opinion of counsel or by means of a private Treasury ruling.¹¹

This article will first consider whether or not a favorable resolution of the section 306 problem raised with respect to convertible preferred stock to be issued in a corporate reorganization is justifiable, given the purpose of section 306. In other words, should convertible preferred stock issued in a corporate reorganization constitute and be taxed upon disposition as section 306 stock? This article will then consider whether, under current law, convertible preferred stock does not in fact constitute, or will not in fact be taxed upon disposition as, section 306 stock. And finally, this article will suggest those changes which might be made in the present law so that proper tax treatment might be given convertible preferred stock issued in a corporate reorganization, consistent with the purpose of section 306.

I. THE NATURE OF THE PROBLEM

A. *The Scope and Purpose of Section 306*

Both the Senate and House Committee reports on the Internal Revenue Code of 1954 indicate that section 306 was designed to eliminate tax-favored preferred stock "bailouts."¹² The word "bail-out" evolved long before 1954, to describe the device whereby share-

⁹ 4 CAVITCH § 92.01(1), at 1133-34. Kanter, *Voting Preferred Stock Given in "B" Reorganization May Be Section 306 Stock*, 39 TAXES 88, 89 (1961) [hereinafter cited as Kanter, *Preferred Stock in "B" Reorganization*]; Vartan, *supra* note 2. It is interesting to note that two authorities believe that convertibles are for the speculative investor. 1 A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 262 (1953); GRAHAM 601. Query whether the shareholders of an acquired corporation are primarily interested in speculation.

¹⁰ INT. REV. CODE OF 1954, § 306.

¹¹ See 1 CCH SINCLAIR-MURRAY CAP. CHANGES REP. 1391, 1529, A-348; 4 CCH SINCLAIR-MURRAY CAP. CHANGES REP. P-345, for examples of companies which evidently have sought such advice.

¹² S. REP. No. 1622, 83d Cong., 2d Sess. 46 (1954); H.R. REP. No. 1337, 83d Cong., 2d Sess. 36 (1954).

holders "bailed" accumulated earnings and profits out of a corporation at capital gains rates, without diluting their common equity position.¹³

The classic pre-1954 bailout case is *Chamberlin v. Commissioner*.¹⁴ In *Chamberlin*, redeemable preferred dividend shares were issued pro rata to the common shareholders of a small, closely held corporation. Thereafter, the preferred shares were sold by the common shareholders to two insurance companies pursuant to the terms of a purchase agreement executed after issuance of the additional stock. Under the terms of the purchase agreement, all of the preferred shares were to be redeemed by the issuing corporation over a seven-year period, so that ultimately the insurance companies would be reimbursed for their cash outlay. As a result of the transactions, the common shareholders of the issuing corporation received cash while retaining their pre-dividend equity position. The insurance companies, on the other hand, were assured of a small fee—the difference between the purchase and redemption prices—for their participation. The Court of Appeals for the Sixth Circuit held that the proceeds of the sale of the preferred stock to the insurance companies did not constitute ordinary income to the common shareholders, rejecting the argument that the transaction in reality represented a distribution of accumulated earnings and profits. The common shareholders were therefore taxed only at capital gains rates.

Chamberlin provoked congressional enactment of a new statutory provision—section 306 of the Internal Revenue Code of 1954, which provides that the disposition of certain stock, designated as "section 306 stock," will give rise to ordinary income. Although section 306 was designed primarily in order to avoid *Chamberlin*-type bailouts,¹⁵ the fact that section 306 stock is defined¹⁶ to include more than an ordinary preferred stock dividend issued to the holders of common stock indicates that Congress, in enacting section 306, intended to discourage the use of all bailout devices involving the issuance of additional shares of stock.

Thus, in the definitional provisions of section 306, Congress included a subsection relating to shares issued in recapitalizations,

¹³ "Bailouts" are defined briefly in the following articles: Alexander & Landis, *Bail-outs* 909-10; Cohen, Silverman, Surrey, Tarleau, & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 403 (1955); Trimble, *The Treatment of Preferred Stock Distributions in Reorganizations Under Section 306 of the Internal Revenue Code of 1954*, 19 TAX L. REV. 345 (1964) [hereinafter cited as Trimble, *Treatment of Preferred Stock Distributions*].

¹⁴ 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1959). The facts of *Chamberlin* are clearly set forth in SECTION 306 STOCK, TAX MANAGEMENT PORTFOLIO No. 85, at 7-8 (1963).

¹⁵ See Trimble, *Treatment of Preferred Stock Distributions* 351, 353.

¹⁶ INT. REV. CODE OF 1954, § 306(c).

reorganizations and corporate divisions.¹⁷ Recapitalizations were included because they are closely akin to transactions involving the issuance of a pure stock dividend. If, for example, a corporation with only twenty-dollar par common shares issued and outstanding issues five preferred shares and five forty-dollar par common shares in exchange for ten twenty-dollar par common shares, the net result will be the same as though the corporation had in the first instance issued a preferred stock dividend. Similarly, reorganizations and divisions may involve a disguised corporate dividend. If, for example, Corporation A merges into Corporation B, and if the shareholders of Corporation A receive, in exchange for their common shares, both preferred and common stock in Corporation B, the net result may be the same as though prior to the merger Corporation A had issued a preferred stock dividend, and thereafter the shareholders of Corporation A had received common stock of Corporation B in exchange for their common shares of A and preferred stock of B in exchange for their preferred stock dividend.

In addition to recognizing the bailout potential of recapitalizations, reorganizations and divisions, Congress, in enacting section 306, recognized the fact that a bailout of earnings and profits might occur despite the absence of shareholder motivation to avoid an ordinary income tax. Thus, section 306 stock need not be issued in a transaction "having as one of its principal purposes the avoidance of Federal income tax."¹⁸ Section 306(b)(4) does provide that upon the disposition of section 306 stock, a capital gains as opposed to an ordinary income tax will be imposed if it can be established that the distribution and/or disposition of the stock were not in pursuance of a plan having tax avoidance as one of its principal purposes. But section 306(b)(4) does not purport to affect the definition of section 306 stock, in that, by its terms, it requires proof that the disposition of stock was not in pursuance of a tax avoidance scheme. Section 306 raises two separate issues, the second of which can be resolved only upon the disposition of newly distributed shares.¹⁹ Thus, the term "bailout" will be used throughout this article in reference to any device, regardless of motive, by which accumulated earnings and profits can be withdrawn from a corporation in such a way that under ordinary circumstances a capital gains tax would be imposed without a substantial shift in common equity position.

¹⁷ INT. REV. CODE OF 1954, § 306(c)(1)(B).

¹⁸ INT. REV. CODE OF 1954, § 306(b)(4).

¹⁹ In light of the discussion concerning motive, it is interesting to note Trimble's suggestion: § 306(b)(4) implies that Congress, in enacting § 306, intended to discourage only *Chamberlin*-type "maneuvers." Trimble, *Treatment of Preferred Stock Distributions* 353.

Because section 306 stock need not be issued in a transaction having tax avoidance as one of its principal purposes and may be issued in a recapitalization, reorganization or corporate division, it would seem clear that Congress, in enacting section 306, intended to do more than discourage *Chamberlin*-type bailouts. But in one respect, Congress apparently intended to do no more. Generally, section 306 stock would appear to consist only of preferred stock issued with respect to common.²⁰

Sections 306(c)(1)(A) and (B) of the Code indicate that common stock issued with respect to common, whether as a stock dividend or as part of a corporate reorganization, division or recapitalization, can under no circumstances be characterized as section 306 stock. These sections are sound, given the purpose of section 306. As a practical matter, common stock issued with respect to common will not enable shareholders to bail earnings and profits out of an enterprise at favorable capital gains rates. Preferred stock is peculiarly suited to a bailout of earnings and profits because preferred stock may be, and generally is, redeemable at the option of the issuing corporation. When preferred dividend shares are redeemed, accumulated earnings and profits are withdrawn from the issuing or acquired corporation. Common stock, on the other hand, generally is not redeemable;²¹ and indeed the law of some jurisdictions may prohibit the issuance of redeemable common shares.²²

Even assuming, however, that common shares generally were redeemable, so that their issuance would enable common shareholders to withdraw accumulated earnings and profits from an enterprise by means of a redemption, section 302²³ would appear to prevent withdrawals at favorable capital gains rates. Section 302 provides that a redemption will give rise to a capital gains tax only if it is in complete termination of a shareholder's equity interest in an enterprise, if it is not essentially equivalent to a dividend, or if it is substantially disproportionate.²⁴ The redemption of common dividend shares issued to common shareholders on either a pro rata or a non-pro rata basis, generally will satisfy none of the prerequisites for capital gains treatment under section 302, and thus an ordinary income tax will be imposed (and a bailout foreclosed).

It is true that, in the typical bailout situation, the section 302 hurdles can be overcome by the sale of dividend shares to a third party,

²⁰ This is preferred stock issued to common shareholders. See INT. REV. CODE of 1954, § 306(e).

²¹ Alexander & Landis, *Bail-Outs* 919 n.30.

²² Note, *Callable Common Stock*, 68 HARV. L. REV. 1240, 1243 (1955).

²³ INT. REV. CODE of 1954, § 302.

²⁴ See the discussion of § 302 at text accompanying notes 145-47 *infra*.

in whose hands the shares subsequently are redeemed. But if redeemable common shares are issued to common shareholders on a dividend basis, the shareholders will be reluctant to sell their shares to a third party with the expectation that the shares will subsequently be redeemed, for a number of circumstances might prevent the redemption²⁵ and thereby cause a dilution of their existing equity position.

Just as common stock issued with respect to common is unsuited to a bailout of accumulated earnings and profits, so also is common stock issued with respect to preferred unsuited to such a bailout. Section 306(c)(1)(B) recognizes this by providing that no common stock issued in a corporate reorganization, division or recapitalization may constitute section 306 stock. On the other hand, one may question why section 306(c)(1)(A), dealing with section 306 stock dividends, excludes only common stock issued with respect to common. It could be that Congress felt it unnecessary to exclude common stock dividends issued with respect to preferred due to their infrequent use.

Common stock issued with respect to preferred is unsuited to a bailout of earnings and profits for two basic reasons. First, it is unlikely that common shareholders will authorize the issuance of a common stock dividend to the holders of preferred shares alone, for if the dividend shares are not or cannot be redeemed, the equity position of the original common shareholders will be diluted. Second, if a redeemable common stock dividend is issued to preferred shareholders who otherwise own no common stock, the equity position of these shareholders will be increased, so that subsequent redemption of the dividend shares will result in a dilution of their equity position and will undoubtedly be substantially disproportionate pursuant to the provisions of section 302²⁶ (assuming that the common shares carry voting rights and the preferred shares are non-voting).

Only preferred stock, then, can constitute section 306 stock. Technically, section 306 preferred stock may be issued with respect to either common or preferred shares, for there are no Code provisions indicating that section 306 preferred stock must be issued with respect to common.²⁷ But, generally speaking, section 306 preferred stock will be issued only with respect to common,²⁸ for it is only in rare instances

²⁵ For example, a controlling shareholder and director, initially in favor of redemption, ultimately might vote against redemption of the common dividend shares.

²⁶ INT. REV. CODE OF 1954, § 302(b)(2).

²⁷ See Trimble, *Treatment of Preferred Stock Distributions* 352.

²⁸ The Treasury has on occasion maintained that a preferred stock dividend issued with respect to preferred constitutes § 306 stock. Eisenberg, *Corporate Reorganization Problems with Redemptions and Preferred Stock*, 25 J. TAXATION 278, 281 (1966). Query whether the Treasury will continue to maintain that certain preferred shares issued with respect to preferred constitute § 306 stock. See the discussion of § 4, Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, at 1234, text accompanying note 41 *infra*. Section 4 of this procedure does not indicate whether the preferred shares

that a preferred stock dividend will be issued to the holders of preferred shares.²⁹

Thus, in order to eliminate or penalize the use of all bailout devices, Congress in 1954 enacted a statutory provision under which preferred stock issued with respect to common, either as a stock dividend or as part of a corporate reorganization, division or recapitalization, might constitute section 306 stock, regardless of the reason for its issuance.

At the same time, Congress enacted several provisos to section 306, so that not all dispositions of section 306 stock need give rise to ordinary income. In enacting these provisos, Congress recognized the fact that the disposition of some preferred stock issued with respect to common will not result in the bailout of accumulated earnings and profits. Many of the provisos to be found in section 306 are discussed in Part III of this article.

B. *The Problems Raised by Convertible, Redeemable Preferred Stock Issued in a Corporate Reorganization*

Given the scope and purpose of section 306, where does convertible preferred stock issued in a corporate reorganization fit into the picture, assuming (as this article will) that such convertible stock is redeemable at the option of the issuing corporation? In other words, should convertible preferred stock issued in a corporate reorganization constitute and be taxed upon disposition as section 306 stock?

It should be noted at the outset that two factors are irrelevant to the solution of the first portion of this problem: first, the hypothesis that the convertible shares were issued as part of a corporate reorganization (as this article earlier indicates, section 306 stock may be, although need not be, issued as part of a reorganization),³⁰ and second, the principal motive behind the issuance of the shares (motive, according to the evident congressional intent, being relevant only upon the disposition of section 306 shares).³¹ Thus, whether or not convertible

must be issued with respect to common or preferred stock. Apparently this is irrelevant, so that the government must now believe that preferred stock issued with respect to preferred in a corporate reorganization cannot be characterized as § 306 stock. *But see* Treas. Reg. § 1.306-3(d), ex. (2).

²⁹ When there are sufficient earnings and profits, a preferred stock dividend may be issued to the holders of cumulative preferred stock in order to wipe out dividend arrearages. 1 A. DEWING, *THE FINANCIAL POLICY OF CORPORATIONS* 781 (1953). Section 305(b)(1) of the Code inadequately deals with this problem by providing that the distribution of a stock dividend will give rise to ordinary income "to the extent that the distribution is made in discharge of preference dividends for the taxable year of the corporation in which the distribution is made or for the preceding taxable year." INT. REV. CODE OF 1954, § 305(b)(1) (emphasis added). When § 305(b)(1) does not apply, the dividend shares should probably constitute § 306 stock.

³⁰ See text accompanying note 17 *supra*.

³¹ See text accompanying notes 18-19 *supra*.

preferred shares issued as part of a corporate reorganization should be regarded as section 306 stock depends solely upon whether convertible preferred stock is to be viewed as common stock or as preferred stock for purposes of section 306—common stock falling without the scope of section 306, and preferred stock constituting section 306 stock if issued with respect to common. The solution to this problem, in turn, depends upon the bailout potential of convertible preferred.

In order to analyze the problem, let us take a hypothetical situation in which Corporation X merges into Corporation Y. Assume that prior to the merger the disappearing corporation (X) had four shareholders, each of whom owned one-quarter of the corporation's one hundred-dollar par common stock, the only class of stock issued and outstanding. Assume, in addition, earnings and profits equal to the par value of the common stock issued and outstanding. After the merger, the four shareholders end up with voting common and voting convertible preferred stock in the surviving corporation (having ten shareholders in addition to the four)³² with the same value as the book value of the common stock surrendered. Further, the convertible preferred shares of the surviving corporation received by the four shareholders have the same par value as the book value of the common shares received, so that each shareholder of the disappearing corporation ends up with one-quarter of the new common and one-quarter of the new preferred stock issued in exchange for the old common shares. Finally, each preferred share is convertible into one common share at a fixed price.

HYPOTHETICAL CASE

HOLDINGS OF SHAREHOLDERS OF DISAPPEARING CORPORATION PRIOR AND SUBSEQUENT TO MERGER

<u>Shareholder</u>	<u>Prior to Merger</u>		<u>After Merger *</u>	
	<u>Common (par)</u>	<u>Earnings and Profits</u>	<u>Common (book)</u>	<u>Convertible Preferred (par)</u>
A	5 units	5 units	5 units	5 units
B	5 units	5 units	5 units	5 units
C	5 units	5 units	5 units	5 units
D	5 units	5 units	5 units	5 units

NOTE: One unit has a fixed value.
All units represent voting stock.

* It is assumed that there are ten other shareholders in the surviving corporation; only A through D are shown here.

³² It is the author's opinion that in a reorganization context, the § 306 problem cannot realistically be discussed in terms of an acquired shareholder's position vis-a-vis

Because each of the four shareholders of the disappearing corporation start out with one-quarter of the common stock of that corporation, and end up with preferred stock plus one-quarter of the common stock issued to them in the surviving corporation (this common stock having the same book value as the par value of the common stock given up), it is arguable that all the conditions necessary for a bailout exist. Each shareholder arguably may sell his five units of convertible preferred stock to the surviving corporation or to a third party without jeopardizing his common equity position³³ insofar as his position with respect to his fellow shareholders of the disappearing corporation is concerned. Thus, the shareholder, in effect, may bail his interest in the earnings and profits of the disappearing corporation out of the surviving corporation, to which these earnings were transferred as a result of merger, provided that the convertible preferred shares are ultimately redeemed.³⁴

Whether or not each shareholder in reality may dispose of his convertible preferred without jeopardizing his common equity position, however, depends upon what happens to the twenty units of convertible stock issued to the four shareholders.³⁵ If shareholder *A* alone converts his five units, and subsequently the preferred shares of *B*, *C* and *D* are redeemed, it would appear that the transaction involving issuance of the preferred shares to *B*, *C* and *D* and their redemption could not be labeled a bailout. Due to *A*'s conversion and the subsequent redemption, *B*, *C* and *D* end up with only one-fifth of the common stock in the surviving corporation held by the former shareholders of the disappearing corporation. Thus, the proceeds of the redemption of *B*, *C* and *D*'s preferred shares, or a portion thereof, should represent compensation for a reduced equity interest.³⁶

This conclusion appears to follow from section 302(b)(2),³⁷ which deals with substantially disproportionate redemptions. Section

both the shareholders of the acquiring corporation and his fellow acquired shareholders. The issue, it would seem, is whether, as the result of a reorganization, an acquiring shareholder has been able to withdraw accumulated earnings and profits of the acquired corporation from the new enterprise, without affecting his common equity position vis-a-vis his fellow acquired shareholders.

³³ The term "common equity position" is used here in the sense of claim upon earnings and claim upon assets in liquidation.

³⁴ See Alexander & Landis, *Bail-Outs* 923-25.

³⁵ *Contra*, Darrell, *Recent Developments in Nontaxable Reorganizations and Stock Dividends*, 61 HARV. L. REV. 958, 975 (1948).

³⁶ Due to *A*'s conversion, *B*, *C* and *D* each lose five per cent of their interest in common stock of the surviving corporation held by the former shareholders of the disappearing corporation. Arguably, then, five per cent of the value of the common shares should be deducted from each individual's redemption proceeds in order to determine the extent of the bailout of earnings and profits.

³⁷ Section 302(b)(2) would clearly appear to be relevant for purposes of determining whether a reduction of equity interest is sufficient to justify the imposition of a capital gains as opposed to an ordinary income tax. This conclusion is reinforced

302(b)(2) provides that a capital gains tax will be imposed upon the redemption of stock, if the percentages of voting and common stock held by a redeemed shareholder after the redemption are less than eighty per cent of such percentages prior to the redemption. Taking the transactions described above as a unit, *B*, *C* and *D* each start out with one-quarter of the voting and common stock of the surviving corporation and each end up with one-fifth of the voting and common stock of the corporation (assuming, for purposes of discussion, that *A*, *B*, *C* and *D* are the only shareholders of the surviving enterprise). This is exactly eighty per cent of their former holdings of common and voting stock, so that the requirements of section 302(b)(2) have virtually been met. Thus, an application of section 302(b)(2) would appear to support the conclusion that all or a portion of the proceeds of the redemption of *B*, *C* and *D*'s preferred shares should represent compensation for a reduced equity interest.

A different conclusion would follow, on the basis of section 302(b)(2), if *A* converted two units of his convertible preferred shares and thereafter the remaining convertible shares (held by *A*, *B*, *C* and *D*) were redeemed. In such a case, *B*, *C* and *D* would each start out with twenty-five per cent of both the voting and common stock of the surviving corporation held by the former shareholders of the disappearing corporation, and would each end up with approximately twenty-three, as opposed to twenty, per cent of this stock—not as substantial a reduction in equity position. *A*'s equity position, on the other hand, would be increased. Thus, it would appear that the proceeds of the redemption of *A*, *B*, *C* and *D*'s preferred shares should represent ordinary income as opposed to compensation for a reduced equity interest.

Suppose, now, that shareholder *A*'s preferred stock is redeemed prior to conversion. Whether or not the redemption represents a bailout of accumulated earnings and profits depends upon what happens to the convertible shares of *B*, *C* and *D*. If these shares are redeemed, a bailout will result not only with respect to *A*, but also with respect to *B*, *C* and *D*. Here section 302(b)(2) would support what should be the resulting tax impact, in that redemption results in no change in the percentage ownership of common and voting stock. If *B*, *C* and *D* convert their preferred shares,³⁸ however, the reduced equity problem

by the author's opinion that § 306 and § 302 were designed to operate as a unit—§ 306 to close the tax loopholes created by the predecessor of § 302, and § 302 to have certain independent significance in the bailout field. See the discussion of §§ 306 and 302, at text accompanying notes 23-26 *supra*.

³⁸ It is worth noting at this point that stock splits, recapitalizations, reductions in par value and stock dividends, among other things, will dilute a conversion privilege. 4 CAVITCH § 92.01(3), at 1137-38; Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1, 20-21 (1930). Such factors therefore will have an impact upon a shareholder's decision with respect to conversion.

raised above with respect to *B*, *C* and *D* is presented again with respect to *A*.

If shareholder *A* sells his preferred stock prior to conversion, more difficult problems arise. Whether or not a bailout has occurred depends upon whether or not the shares will be converted by the purchaser,³⁹ and upon whether or not *B*, *C* and *D* will later convert their shares. If the shares are converted by the purchaser, *A* will end up with only a one-fifth interest in the common stock of the surviving corporation (assuming that shareholders *A*, *B*, *C*, *D* and the purchaser are the only common shareholders). In this case, the proceeds of sale, or a portion thereof, should represent compensation for a reduced equity interest, rather than ordinary income.⁴⁰ Alternatively, if the shares are redeemed in the hands of the purchaser, and *B*, *C* and *D* later convert, leaving *A* with only a one-seventh interest in the common stock of the surviving corporation issued to shareholders of the disappearing corporation, the proceeds from the sale of *A*'s preferred shares, or a portion thereof, should again represent compensation for a reduced equity interest, rather than ordinary income. This conclusion would appear to follow from the underlying philosophy of section 302(b)(2).

The conversion privilege, then, is the factor which makes it impossible to state conclusively that the issuance of convertible preferred stock to common shareholders in a corporate reorganization will in all instances enable the shareholders to bail earnings and profits of the acquired corporation out of the acquiring corporation without impairing their common equity position. In some instances, however, the issuance of convertible preferred stock will give rise to a bailout of earnings and profits, so that it becomes impossible to categorize all convertible preferred shares as common stock or as preferred stock for purposes of section 306. Therefore, all convertible preferred shares issued in a corporate reorganization should initially be regarded as section 306 stock.

Whether or not such convertible preferred, section 306 shares should be taxed upon disposition as section 306 stock must again depend upon whether or not the disposition of these shares will give rise to a bailout of earnings and profits. As the discussion above indicates, the result is uncertain. Only if the holder of convertible preferred shares exercises his conversion privilege prior to the sale can one assert conclusively that the disposition of his shares will not result in a bailout of earnings and profits. And only if all convertible preferred

³⁹ Here, too, it is worth noting that a conversion privilege is transferable, although it must be exercised within the period of time set forth in the instrument creating the privilege, or within a reasonable time. Hills, *supra* note 38, at 3, 15-16.

⁴⁰ See Harris, *The Status of Preferred Stock Bail-Outs*, 34 TAXES 403, 408 (1956).

shares issued in a corporate reorganization are redeemed in the hands of, or subsequent to their sale by, the original holder can one assert conclusively that disposition of the shares has given rise to a bailout of earnings and profits. Thus, in certain instances, convertible preferred stock issued in a corporate reorganization should be taxed upon disposition as section 306 stock, while in other instances it should not.

II. THE STATUTORY SCHEME: DOES CONVERTIBLE PREFERRED STOCK ISSUED IN A CORPORATE REORGANIZATION CONSTITUTE SECTION 306 STOCK?

Special section 306 problems, then, are created by convertible preferred stock issued in a corporate reorganization. The Code and regulations have resolved these peculiar section 306 problems by ignoring them. Section 306(c)(1)(B), defining section 306 stock issued in a reorganization, and the accompanying regulations fail to indicate whether or not convertible preferred shares issued in a reorganization are to be treated as ordinary preferred or as common stock for purposes of section 306, although section 306(e)(1) implies the former. And until quite recently, the Commissioner had issued neither a public ruling nor a revenue procedure dealing specifically with such convertible preferred shares.

A. *Section 4 of Revenue Procedure 66-34*

Revenue Procedure 66-34⁴¹ is the only published revenue procedure which deals with convertible preferred stock. Section 4 of the procedure provides that a ruling usually will be issued to the effect that, in a corporate reorganization, convertible preferred stock issued to shareholders who receive no common shares will not be regarded as section 306 stock, provided that the convertible stock is widely held or provided that there will be no conversion pursuant to a plan enabling shareholders ultimately to hold both common and preferred shares. The procedure goes no further.

The procedure does indicate, however, that the Treasury will not expressly treat all convertible preferred stock issued in a corporate reorganization as common stock for purposes of section 306. This decision is consistent not only with statutory purpose, but also with prior rulings and case law. Although the Treasury might have concluded that convertible preferred stock issued in a reorganization falls within the common stock exception to section 306, such a conclusion could not have withstood attack under such prior authority.

⁴¹ 1966-2 CUM. BULL. 1232, 1234.

Three alternative approaches were open to the Treasury, each of which is worth exploring.

The Treasury might first have concluded that convertible preferred stock falls within the corporate definition of common stock and therefore must be regarded as common stock for purposes of section 306. This conclusion is based upon two premises: (1) that the meaning of the term "common stock," as used in section 306, must be found in corporate law; and (2) that under corporate law, convertible preferred stock does indeed constitute common stock. The first premise is in fact defensible. Because section 306 does not define the term "common stock," and because the Senate Report does not shed any light upon the matter,⁴² it is arguable that Congress felt that corporate law would supply the missing definition.⁴³ The second premise, however, is clearly indefensible. Although the definitions of common stock under corporate law are diverse,⁴⁴ a frequently quoted definition⁴⁵ provides that common stock is stock enabling the holder "to make profit if there is any, and participate in the assets after all other claims are paid, and bear the loss if there be such."⁴⁶ This definition clearly has no application to convertible preferred shares prior to their conversion. Thus, the second premise is invalid and the first alternative approach was properly rejected by the Treasury.

Assuming that the meaning of the term "preferred stock" must be found in corporate law, however, the Treasury might secondly have concluded that convertible preferred does not fall within the corporate definition of preferred stock and thus must be regarded as common stock for the purposes of section 306. There is some support for the argument that convertible preferred stock issued in a corporate reorganization does not constitute preferred stock as the term is used in corporate law. The Court of Appeals for the Ninth Circuit⁴⁷ has indicated that preferred stock "differs . . . from other stocks in that it is given preference and has no voting rights."⁴⁸ Because con-

⁴² See Kanter, *Preferred Stock in "B" Reorganization* 90 n.6.

⁴³ Kanter assumes that case law must supply the statutory definition of common stock. Presumably he means corporate case law. *Id.* Alexander and Landis, however, suggest that statutory purpose should be considered in determining the definition of common stock for purposes of § 306. Alexander & Landis, *Bail-Outs* 918-19. In reality, Congress probably intended that both corporate law and statutory purpose should supply the missing definition.

⁴⁴ Alexander & Landis, *Bail-Outs* 918.

⁴⁵ The definition is found in *General Inv. Co. v. Bethlehem Steel Corp.*, 87 N.J. Eq. 234, 100 A. 347 (1917), cited in 11 W. FLETCHER, *PRIVATE CORPORATIONS* § 5086, at 55 n.35 (perm. ed. rev. 1958).

⁴⁶ 87 N.J. Eq. at 242, 100 A. at 351.

⁴⁷ *Elko Lamoille Power Co. v. Commissioner*, 50 F.2d 595 (9th Cir. 1931).

⁴⁸ *Id.* at 596. See Rev. Rul. 57-132, 1957-1 CUM. BULL. 115, where common stock which had no voting rights and which was redeemable at the discretion of the corporation was found to be § 306 stock.

vertible preferred stock issued in a corporate reorganization generally will carry voting rights, it would follow from the Ninth Circuit's statement that such stock could not be characterized as preferred stock under corporate law. Thus, under this second approach, the Treasury might have concluded that such stock must be regarded as common stock for purposes of section 306. The approach, however, is unsound. Its first major weakness lies in the fact that, contrary to the statement of the Ninth Circuit, recently-issued, ordinary preferred shares often carry voting rights.⁴⁹ A second major weakness lies in the probable invalidity of the premise that stock which does not fall within the corporate definition of preferred stock must be regarded as common stock for purposes of section 306. Thus, the second alternative approach was also properly rejected.

There remains a third approach: that for purposes of section 306, convertible preferred stock must be regarded as common stock due solely to the conversion privilege. There is some authority for focusing upon what shares may ultimately become. Section 306(e)(2) provides that "common stock with respect to which there is a privilege of converting into stock other than common stock . . . shall not be treated as common stock." Further, an old Treasury memorandum⁵⁰ holds that rights enabling shareholders to subscribe to bonds which are convertible into stock are to be considered substantially the same as stock rights.

Neither section 306(e)(2) nor the Treasury memorandum, however, conclusively indicates that the tax law enables one to focus upon what shares may ultimately become for purposes of applying the provisions of the Code. It is difficult to draw such an inference from section 306(e)(2), which was enacted in order to close a potential loophole—the issuance of convertible common shares.⁵¹ Further, with respect to the Treasury memorandum, *Tax Management* states that the Service has doubts about the position taken in the memorandum,⁵² while a relatively recent ruling⁵³ suggests the present unsoundness of the memorandum, concluding that convertible certificates received in a statutory merger may not be treated as stock for purposes of section

⁴⁹ See Harris, *supra* note 40, at 406-07. Preferred shares listed on the New York Stock Exchange must carry certain voting rights, NYSE COMPANY MANUAL A-15, and under many state corporation laws, preferred shares must carry voting rights unless the corporate charter otherwise provides. 4 CAVITCH § 88.03(2)(d)(i), at 841-44.

⁵⁰ G.C.M. 13275, XIII-2 CUM. BULL. 121 (1934).

⁵¹ Alexander & Landis, *Bail-Outs* 919.

⁵² See SECTION 306 STOCK, TAX MANAGEMENT PORTFOLIO No. 85, at 33 (1963).

⁵³ Rev. Rul. 57-586, 1957-2 CUM. BULL. 249. The certificates were convertible into common stock.

356.⁵⁴ Thus the third alternative approach as well was properly rejected by the Treasury.

The approach actually taken in Revenue Procedure 66-34 indicates that the Treasury will not expressly treat all convertible preferred as common stock for purposes of section 306. Indeed, the Revenue Procedure goes further, suggesting that the Treasury will generally consider convertible preferred shares as ordinary preferred for purposes of ascertaining their section 306 character.⁵⁵ This conclusion follows from the fact that in the two non-section 306 stock reorganization situations described in Revenue Procedure 66-34, ordinary preferred stock probably would not have been categorized by the Treasury as section 306 stock under the rules developed by the government for ascertaining the presence or absence of section 306 shares.

The first of the two non-section 306 situations described in Revenue Procedure 66-34 involved the issuance in a reorganization of convertible preferred stock to shareholders who received no common shares, it being "represented that there [would] not be any conversion of the convertible preferred stock pursuant to a concerted plan which [would] result in both preferred and common stock being held by an exchanging shareholder."⁵⁶ The conversion proviso in the first situation suggests that the convertible shares were being likened to ordinary preferred, which could clearly not have been characterized as section 306 stock under the government's so-called cash substitution test.⁵⁷

The second non-section 306 situation described in Revenue Procedure 66-34 involved the issuance, as part of a corporate reorganization, of convertible preferred stock to shareholders receiving no common shares, the convertible stock being "widely-held." As this article later indicates,⁵⁸ ordinary preferred shares which are widely held under many circumstances will not be regarded as section 306 stock. And thus, the second situation further suggests that convertible preferred shares will be likened by the government to ordinary preferred in order to ascertain their section 306 character.⁵⁹

⁵⁴ INT. REV. CODE OF 1954, § 356.

⁵⁵ In the past, the Treasury has treated convertible preferred as ordinary preferred stock in order to ascertain its § 306 character. In a private ruling cited in a 1963 law review note, the Treasury held that convertible preferred stock issued in a corporate reorganization constituted § 306 stock, but there was apparently no recognition of the fact that convertible preferred stock constitutes a commodity distinct from regular preferred. Letter from Harold T. Swartz, Assistant Commissioner of the Internal Revenue Service to C. Rudolph Peterson, August 23, 1961, cited in Note, *Exclusion from Section 306 Treatment in Unifying Reorganizations*, 76 HARV. L. REV. 1627 (1963) [hereinafter cited as Note, *Exclusion from Section 306 Treatment*].

⁵⁶ 1966-2 CUM. BULL. 1232, 1234.

⁵⁷ The cash substitution test is discussed at text accompanying notes 62-90 *infra*.

⁵⁸ See the discussion at text accompanying notes 91-105 *infra*.

⁵⁹ At least one author suggests, particularly on the basis of § 306(e)(1), that, under current law, convertible preferred stock must be regarded as ordinary preferred

B. *Ordinary Preferred as Section 306 Stock: The Government's Pure Cash Substitution Test*

Thus, Revenue Procedure 66-34 implies that convertible preferred stock issued in a corporate reorganization will constitute section 306 stock only if ordinary preferred would be regarded as section 306 stock under the given circumstances. It therefore becomes necessary to consider the criteria which have been developed for ascertaining whether or not ordinary preferred stock issued in a given corporate reorganization constitutes section 306 stock.

Section 306(c)(1)(B) defines section 306 stock as:

Stock which is not common stock and (i) which was received . . . in pursuance of a plan of reorganization . . . and (ii) with respect to the receipt of which gain or loss to the shareholder was to any extent not recognized by reason of [the reorganization provisions], but only to the extent that . . . the effect of the transaction was substantially the same as the receipt of a stock dividend⁶⁰

The primary problem raised by section 306(c)(1)(B) concerns the meaning of the qualifying phrase, "the effect of the transaction was substantially the same as the receipt of a stock dividend."⁶¹ In an effort to clarify the phrase, section 1.306-3(d) of the regulations provides that:

Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) . . . if cash received in lieu of such stock would have been treated as a dividend under section 356(a)(2) or would have been treated as a distribution to which section 301 applies by virtue of . . . section 302(d).⁶²

This regulation, popularly known as the cash substitution test, apparently is a simple solution to the problem raised by the qualifying phrase of section 306(c)(1)(B). Indeed, it would be simple (if not

for purposes of § 306. Harris, *supra* note 40, at 408. Basing the the suggestion on § 306(e)(1) may not be sound. Section 306(e)(1) indicates that convertible preferred shares may constitute § 306 stock, but from this it does not follow that § 306(e)(1) assumes that convertible preferred shares must be regarded as ordinary preferred for purposes of ascertaining their § 306 character.

⁶⁰ INT. REV. CODE OF 1954, § 306(c)(1)(B).

⁶¹ *Id.* § 306(c)(1)(B)(ii). It is interesting to note that prior to enactment of the 1954 Code, one author made the following comment: "Upon the basis of the [stock dividend cases] it is submitted with confidence that, in the law of taxation, the phrase 'stock dividend' denotes the issuance of a more or less permanent equity security; and that short-term redeemable preferred stock does not meet that requirement." Dauber, *Preferred Stock Dividends: Permanency of Interest and the Federal Income Tax Law*, 8 RUTGERS L. REV. 472, 480-81 (1954) (footnote omitted).

⁶² The words omitted before the phrase "section 302(d)" are "section 356(b) or." The section references in the quoted passage are to sections of INT. REV. CODE OF 1954.

logical), were it not for the fact that the test permits the government to apply the provisions of either section 356(a)(2) or section 302(d) to hypothetical cash in order to determine the presence or absence of section 306 shares.

As a practical matter, the choice of one of these sections over the other should be irrelevant.⁶³ Section 356(a)(2) provides that if an exchange of stock or securities has the "effect of the distribution of a dividend, then there shall be treated as a dividend" all or a portion of the gain realized by the exchanging shareholder or security holder. Section 302(d) provides that if a corporation redeems its stock, gain or loss will be ordinary, unless certain exceptions set forth in section 302(b) apply, the first exception being that "the redemption is not essentially equivalent to a dividend." The section 356(a)(2) concept of dividend effect should, it would appear, be equated with the section 302 concept of dividend equivalence.⁶⁴ But these concepts have not always been equated in the past,⁶⁵ and thus the choice between section 356(a)(2) and section 302(d) becomes significant insofar as the application of the cash substitution test is concerned.

In applying the cash substitution test, the government apparently has chosen section 356(a)(2),⁶⁶ except in situations in which reliance

⁶³ This despite the fact that the dividend equivalence test set forth in § 306(c)(1)(B)(ii) is essentially the old dividend equivalence test of § 115(g) of the 1939 Code, now § 302(b)(1). See Dean, *Rules Governing Preferred Stock Bail-Outs*, N.Y.U. 14TH INST. ON FED. TAX. 691, 703 (1956).

⁶⁴ The Court of Claims feels that the two concepts should be interpreted in the same manner. See *Ross v. United States*, 173 F. Supp. 793, 797 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *Idaho Power Co. v. United States*, 161 F. Supp. 807, 809 (Ct. Cl. 1958).

⁶⁵ See, e.g., *Commissioner v. Bedford*, 325 U.S. 283 (1945).

⁶⁶ The government has clearly applied the cash substitution test in only one revenue ruling, Rev. Rul. 56-586, 1956-2 CUM. BULL. 214, in which reference was significantly made to § 356(a)(2) of the Code. Revenue Ruling 56-586 involved an "E" reorganization, i.e., a recapitalization. INT. REV. CODE OF 1954, § 386(a)(1)(E). Prior to the recapitalization, two brothers, C and D, owned all the common stock of the corporation, while the preferred was scattered among C, D, their families, a third brother, his family and the general public. For valid business reasons, the preferred shares held for everyone save C and D and their immediate families were redeemed. C, D and their wives and children received in exchange for their old preferred stock either new Class A or Class B preferred. The Service, after finding an "E" reorganization, stated that "the new preferred stock will be treated as 'section 306 stock' . . . to the extent that cash, if received in lieu of such stock, would have been treated as a distribution to which section 301 of the Code applies by reason of the provisions of section 356(a)(2)" Rev. Rul. 56-583, 1956-2 CUM. BULL. at 215. No further conclusions were drawn. But only the preferred stock held by C and D logically could have been found to constitute § 306 stock. Taking into account C's and D's common stock holdings, the substitution of cash as to them would not have resulted in a complete redemption and, further, their new preferred shares were arguably issued with respect to common. See the commentary upon Revenue Ruling 56-586 found in Trimble, *Treatment of Preferred Stock Distributions* 362-64; Note, *Exclusion from Section 306 Treatment* 1638.

The cash substitution test was also applied in Rev. Rul. 59-197, 1959-1 CUM. BULL. 77, but a split-off was involved, and in accordance with the regulations, reference was made to § 356(b), rather than to § 356(a)(2) of the Code.

Consider also Rev. Rul. 56-116, 1956-1 CUM. BULL. 164, and Rev. Rul. 66-332, 1966-2 CUM. BULL. 108.

upon section 356(a)(2) might not produce the desired results.⁶⁷ Because of the structure of, and the law which has evolved under, section 356(a)(2), reference to section 356(a)(2) rather than to section 302 of the Code creates numerous problems which should be irrelevant to the determination whether the effect of a transaction is substantially the same as the receipt of a stock dividend,⁶⁸ which is the question posed by 306(c)(1)(B).

The first problem created by reference to section 356(a)(2) rather than section 302 of the Code concerns the dividend equivalence test to be applied under section 356(a)(2). At least one court would apply a "net effect" test,⁶⁹ under which an exchange will be said to have the effect of the distribution of a dividend if, as a result, a shareholder retains an identical equity interest in the enterprise and at the same time receives disposable "boot."⁷⁰ In a section 306 reorganization context, the net effect approach will produce section 306 stock (assuming that the acquired corporation has undistributed earnings and profits prior to the reorganization)⁷¹ if a shareholder of the acquired corporation receives stock in the acquiring corporation which can be disposed of without affecting his pre-reorganization equity position.

⁶⁷ Alexander and Landis suggest that the government will rely upon § 302 when there is a loss, § 356(a)(2) then being inapplicable. Alexander & Landis, *Bail-Outs* 933. See note 89 *infra*. Trimble suggests that reference will be made to § 302(d) when the substitution of cash results in a complete redemption. Trimble, *Treatment of Preferred Stock Distributions* 363. Consider, however, Rev. Rul. 59-84, 1959-1 CUM. BULL. 71, where the government conceivably may have applied a § 302(b)(1) oriented test of dividend equivalence when there was no need to rely upon § 302 in order to find § 306 stock. In finding § 306 stock, the government stated that after the transaction the shareholders who received preferred owned "a percentage interest in the common stock equity which [was] greater or not substantially less than his percentage interest in such equity before the transaction." Rev. Rul. 59-84, 1959-1 CUM. BULL. at 71.

⁶⁸ In view of these numerous problems, it is difficult to imagine why an advisory group on subchapter C endorsed the formulation set forth in the regulations. See Advisory Group on Subchapter C, *Revised Report on Corporate Distribution and Adjustments, in Hearings on Advisory Group Recommendations Before the Subcomm. on Internal Revenue Taxation of the House Comm. on Ways & Means*, 86th Cong., 1st Sess. 498 (1959).

⁶⁹ The Court of Claims in *Idaho Power v. United States*, 161 F. Supp. 807, 809 (Ct. Cl. 1958), indicated that it would apply a "net effect" test under § 356(a)(2). A net effect test was also applied in Rev. Rul. 59-84, 1959-1 CUM. BULL. 71. But query whether the test was applied after reference to § 356(a)(2), as opposed to § 302(b)(1).

⁷⁰ "Boot" is used here in the sense of money and other property which is taxable in an otherwise tax free transaction. See INT. REV. CODE of 1954, §§ 354, 356(a)(1)(B).

⁷¹ Treas. Reg. § 1.306-3(a) provides that:

Any class of stock distributed to a shareholder in a transaction in which no amount is includible in the income of the shareholder or no gain or loss is recognized may be section 306 stock, provided the distributing corporation has earnings and profits at the time of distribution and for this purpose the total amount of the earnings and profits is immaterial.

See Alexander & Landis, *Bail-Outs* 932 n.64; Kanter, *Preferred Stocks in "B" Reorganization* 92-93 n.13; Stinson, *Some Subchapter C Trouble Spots—After Two Years*, 34 TAXES 890, 904 (1956).

A second test of dividend equivalence, however, has evolved under section 356(a)(2). This is the *Bedford*⁷² doctrine under which boot automatically will be treated as a cash dividend to the extent of accumulated earnings and profits. In a section 306 context, *Bedford* would suggest that all preferred stock issued with respect to common as part of a corporate reorganization must constitute section 306 stock if the acquired corporation has undistributed earnings and profits equal in value to or greater than the value of the newly issued preferred shares.

Whether the government will apply this automatic dividend rule rather than a net effect test in determining the presence or absence of section 306 stock, however, remains unclear. Within the last twelve years, the government has applied the *Bedford* doctrine in a section 356(a)(2) context.⁷³ Thus it could conceivably apply the doctrine today in determining whether or not preferred shares issued in a corporate reorganization constitute section 306 stock.⁷⁴ The one ruling in which the cash substitution test was clearly applied⁷⁵ sheds no light upon the matter.

The second problem which has evolved from reference to section 356(a)(2) rather than section 302 of the Code concerns the disqualification of the underlying reorganization as a tax-free exchange. Although the argument is hyper-technical, some authors have asserted that if the distribution of cash in lieu of preferred stock would have taken the reorganization out of the category of tax-free exchanges, the substitution of hypothetical cash for the preferred stock actually distributed should render application of section 356(a)(2) inapposite due to the fact that section 356 comes into play only if boot is received in an otherwise tax-free reorganization.⁷⁶ The problem is most acute in "B"⁷⁷ and "C"⁷⁸ reorganizations where a corporation must be acquired solely or almost exclusively for voting stock. But a problem does potentially exist with respect to "A" reorganizations.

⁷² *Commissioner v. Bedford*, 325 U.S. 283 (1945).

⁷³ Rev. Rul. 56-220, 1956-1 CUM. BULL. 191. The *Bedford* doctrine may have been applied in Rev. Rul. 57-586, 1957-2 CUM. BULL. 249. See Kanter, *Preferred Stock in "B" Reorganization* 96 n.23. It is interesting to note that the government, in its brief in *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958), took the position that dividend equivalence could be treated as a question of ultimate fact. Brief for Defendant at 31, *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958).

⁷⁴ See Kanter, *Preferred Stock in "B" Reorganization* 96. Query whether the *Bedford* doctrine could be applied, however, given Treas. Reg. § 1.306-3(a) quoted in note 71 *supra*. The regulation provides that "the total amount of the earnings and profits is immaterial."

⁷⁵ Rev. Rul. 56-586, 1956-2 CUM. BULL. 214.

⁷⁶ See Trimble, *Treatment of Preferred Stock Distributions* 376 n.108.

⁷⁷ INT. REV. CODE of 1954, § 368(a)(1)(B); see Alexander & Landis, *Bail-Outs* 935; Kanter, *Preferred Stock in "B" Reorganization* 91-92.

⁷⁸ The problem which arises in connection with "C" reorganizations, INT. REV. CODE of 1954, § 368(a)(1)(C), is discussed in Note, *Exclusion from Section 306 Treatment* 1630.

An "A" reorganization is defined in section 368(a)(1) as a statutory merger or consolidation. No details are mentioned, and thus any merger or consolidation which is valid under state law arguably should qualify as a tax-free exchange, regardless of the amount of voting or non-voting stock distributed to shareholders of the disappearing corporation. But there may be a "continuity of interest" requirement with respect to statutory mergers or consolidations.

The "continuity of interest" test was first mentioned and applied by the Supreme Court in *Pinellas Ice and Cold Storage Co. v. Commissioner*,⁷⁹ decided under the Revenue Act of 1926. The test was incorporated in the 1934 definitions of "B" and "C" reorganizations.⁸⁰ But an "A" reorganization was defined only briefly under the Revenue Act of 1934 as a statutory merger or consolidation.⁸¹ However, in *Roebbling v. Commissioner*⁸² (decided under the Revenue Act of 1938), the Third Circuit determined that a continuity of interest test should be applied to "A" reorganizations. Thus, if a sufficient proprietary interest were not retained by shareholders of the disappearing corporation, the reorganization could not qualify as a tax-free exchange.

In later cases arising under the 1939 Code, the *Roebbling* decision was accepted as precedent.⁸³ There is some doubt, however, whether *Roebbling* is still effective, because boot received in an otherwise tax-free exchange will now be taxable under section 356.⁸⁴ But the existence or non-existence of a tax-free reorganization will have an effect upon the basis of assets received by the transferee corporation and may affect the type of income received by the transferor shareholders—ordinary income or capital gain.⁸⁵

Thus, the substitution of hypothetical cash for preferred stock received by shareholders of the disappearing corporation could disqualify an "A" reorganization as a tax-free exchange. One is therefore compelled, even for statutory mergers or consolidations, to determine whether the government's cash substitution test is rendered inoperative when the underlying exchange cannot qualify as a tax-free transaction once the receipt of cash rather than stock is posited.

⁷⁹ 287 U.S. 462 (1933).

⁸⁰ Revenue Act of 1934, ch. 277, § 112(g)(1)(B) and (C), 48 Stat. 705.

⁸¹ Revenue Act of 1934, ch. 277, § 112(g)(1)(A), 48 Stat. 705.

⁸² 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944).

⁸³ W. H. Truschel, 29 T.C. 433 (1957), acquiesced in, 1960-2 CUM. BULL. 7; Southwest Natural Gas Co., 14 T.C. 81 (1950), aff'd, 189 F.2d 332 (5th Cir.), cert. denied, 342 U.S. 860 (1951).

⁸⁴ See S. SURREY & W. WARREN, FEDERAL INCOME TAXATION, CASES AND MATERIALS 1554-55 (1960); Maxwell, *Continuity of Interest in Recapitalizations and Mergers*, 40 TAXES 1003, 1012 (1962). Under the law as it stood at the time of the *Roebbling* decision (and prior to 1954), boot received in a tax free reorganization was non-taxable, so that the government was required to establish the existence of a non-tax free exchange in order to tax the boot. See note 70 *supra*.

⁸⁵ S. SURREY & W. WARREN, *supra* note 84, at 1554-55.

The final problem created by reference to section 356(a)(2) rather than section 302 of the Code concerns the dividend-within-gain rule of section 356(a)(2). Once it is established that preferred stock issued in a corporate reorganization has the effect of the distribution of a dividend, and once the problem of the disqualification of the reorganization has been overcome, it becomes necessary to determine whether or not the preferred stock is to be treated as section 306 stock only to the extent of realized gain, as section 356(a)(2) would suggest.⁸⁶

The government has never set forth its position,⁸⁷ but it generally is believed that the dividend-within-gain limitation of section 356(a)(2) will not be adhered to when reference is made to section 356(a)(2) under the cash substitution test.⁸⁸ Once the existence of gain is established,⁸⁹ all preferred shares issued with respect to common should be regarded as section 306 stock, provided the other criteria of a section 356-oriented cash substitution test can be met. The fact that the actual receipt of cash (in an "A" or "C" reorganization) causes some or even all of the gain⁹⁰ to be recognized should be irrelevant.

C. Ordinary Preferred as Section 306 Stock: The Government's Modified Cash Substitution Test

Despite the problems created by a cash substitution test based primarily upon section 356 of the Code, there is no indication that the test will be abandoned for a cash substitution test based solely upon section 302. But the government appears to have developed a modified section 356-oriented cash substitution test which takes into account

⁸⁶ See Alexander & Landis, *Bail-Outs* 932; Trimble, *Treatment of Preferred Stock Distributions* 356; cf. Note, *Exclusion from Section 306 Treatment* 1634-36.

⁸⁷ See the discussion of the only ruling which relies upon a § 356(a)(2)-oriented cash substitution test at note 66 *supra*.

⁸⁸ Alexander & Landis, *Bail-Outs* 932; Kanter, *Preferred Stock in "B" Reorganization* 92 n.13, 96 n.21; Stinson, *supra* note 71, at 904.

⁸⁹ Section 356(a)(2) clearly requires the existence of some realized gain. Thus, if there is a loss, § 306 stock cannot be found if reference is made solely to § 356(a)(2). One commentator feels that preferred stock received in a loss transaction should not constitute § 306 stock, due partly to the fact that § 306(c)(2) states that "the term 'section 306 stock' does not include any stock no part of the distribution of which would have been a dividend at the time of the distribution if money had been distributed in lieu of the stock." Section 306(c)(2) indicates that § 306 stock cannot exist absent undistributed earnings and profits. Diamond, *A View of Section 306 or "Taint" Necessarily So*, 17 BUS. LAW 256, 260 (1962). Two other commentators, however, feel that preferred stock issued in a loss transaction may constitute § 306 stock under the government's interpretation of the statute. They realize that a loss transaction cannot give rise to § 306 stock if a cash substitution test based solely upon § 356(a)(2) is applied. Thus it is suggested that § 302 may be applied under the formulation set forth in the regulations. Alexander & Landis, *Bail-Outs* 932-33.

⁹⁰ Section 306(c)(1)(B)(ii) indicates that § 306 stock constitutes, among other things, stock with respect to the receipt of which gain was to any extent not recognized under §§ 354-68. The provision can be read narrowly to mean that there must be some non-recognition of gain, so that if shareholders of the acquired or disappearing

the nature of the acquiring corporation and the extent of ownership of its newly issued preferred shares.⁹¹ An analysis of certain published revenue rulings suggests the following two-part rule of thumb:

1. If the acquiring corporation is publicly held and if the preferred shares issued with respect to common are widely held, the shares will not constitute section 306 stock if, shortly after issuance, they are neither redeemed nor sold in anticipation of redemption.

2. If the acquiring corporation is small and closely held, preferred stock issued with respect to common in the reorganization will constitute section 306 stock if the criteria of the cash substitution test can be met.

Actually, in only one published revenue ruling⁹² has the government held that ordinary preferred shares issued with respect to common in a corporate reorganization (a statutory merger) could not be regarded as section 306 stock, due to the publicly held nature of the surviving corporation and the fact that the preferred shares were widely held.⁹³ There was no indication in the ruling, however, that the shares would have been regarded as section 306 stock had redemption or sale in anticipation of redemption been contemplated.

An earlier ruling⁹⁴ suggests these qualifications. Revenue Ruling 56-116 involved a proposed statutory merger under which both preferred and common shares of Corporation X were to be exchanged

corporation receive cash equal to the realized gain, there may be no § 306 stock. Alexander & Landis, *Bail-Outs* 928; McClure & Reuben, *The Preferred Stock Bail-Out: Section 306 of the '54 Code*, 2 P-H TAX IDEAS ¶¶ 25,001, 25,001.1(3).

But the provision can also be read expansively to mean that there must be some unrecognized gain on the stock-for-preferred-stock exchange involved in the corporate reorganization, but that any cash, which will be treated as boot and taxed at ordinary rates, may wipe out the unrecognized gain on the stock-for-stock exchange without ruling out the existence of § 306 stock.

Note that this discussion is also relevant to a § 302-oriented cash substitution test.

⁹¹ It is interesting to note that the government may have adopted a view expressed by the Tax Court in *C. P. Chamberlin*, 18 T.C. 164 (1952). The court states: "It is our opinion that the issue presented of whether the stock dividend of preferred on common constituted income to the stockholders . . . must be determined from a consideration of all the facts and circumstances surrounding the issuance of such dividend and not by a consideration limited to the characteristics of the stock declared as a dividend."
Id. at 172.

⁹² Rev. Rul. 60-1, 1960-1 CUM. BULL. 143. This ruling involved a recapitalization which was carried out in conjunction with a merger. Trimble criticizes the government's approach to the problem as to whether or not the redeemable preferred stock issued by the surviving corporation to its own shareholders constituted § 306 stock. He feels that the factors relied upon by the government in resolving the problem were relevant only to ascertaining the presence of a plan to avoid taxes. Trimble, *Treatment of Preferred Stock Distributions* 379; cf. Kanter, *Preferred Stock in "B" Reorganization* 99 n.26.

⁹³ With respect to the second point, the Ruling states: "The new preferred stock is not largely owned by the management . . . There is no single dominant group in the survivor corporation." Rev. Rul. 60-1, 1960-1 CUM. BULL. 143, 144.

⁹⁴ Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

for common stock of Corporation Y, the corporation to be acquired. The common stock of both X and Y was widely held, so that presumably the newly issued preferred shares would be widely held.⁹⁵ Although the government held that the newly issued preferred shares would be regarded as section 306 stock, the government went on to state that sale of the shares to a third party would result in ordinary income⁹⁶ only if the sale were in anticipation of redemption.⁹⁷ Thus, although the government was asked only to consider whether or not the proposed preferred shares would be regarded as section 306 stock, the government voluntarily went on to indicate that the preferred shares, even though section 306 stock, would not be taxable at ordinary rates upon a particular form of disposition which apparently had not been presented to the government as a probability at the time that the ruling was issued. Thus, in Revenue Ruling 56-116, the government must have actually held that the preferred shares to be issued in the proposed corporate reorganization would not constitute section 306 stock, if shortly after issuance, they were neither redeemed nor sold in anticipation of redemption.⁹⁸

Revenue Ruling 56-116, and the later ruling discussed above, therefore suggest part one of the suggested two-part rule of thumb,⁹⁹

⁹⁵ The conclusion that the newly issued preferred shares would be widely held is based upon the assumption that the preferred shares would be issued to common shareholders of the acquired corporation on a pro-rata basis.

⁹⁶ Section 306(a)(1) provides that if the disposition of § 306 stock is not a redemption, the entire amount realized will be treated as gain from the sale of property which is not a capital asset, provided that such amount realized equals or exceeds the stock's ratable share of earnings and profits of the acquired corporation at the time of the initial issuance of the stock. No loss will be recognized in the case of a disposition which is not a redemption.

⁹⁷ Section 306(a)(2) provides that if the disposition of § 306 stock is a redemption, the amount realized will be treated as a distribution of property to which § 301 applies. Thus, the amount realized will be taxable as a dividend if the redeeming corporation, at the time of the redemption, has accumulated earnings and profits equal to or greater than the realized amount. Whatever amount is not taxable as a dividend will be applied in reduction of basis; the remainder will constitute capital gain.

⁹⁸ The government's willingness to deal with the distribution and sale of § 306 shares prior to their issuance and to deal with redemptions of § 306 shares at the time of their occurrence has been referred to as a "two bite" approach. Chapman, *Rulings point to exemption of 306 stock in public companies as IRS policy*, 7 J. TAXATION 221, 223 (1957) [hereinafter cited as Chapman, *Exemption of 306 Stock*]. A two bite approach may have been applied in Rev. Rul. 57-103, 1957-1 CUM. BULL. 113, involving a "C" reorganization. In holding that an ordinary income tax would not be imposed upon the sale or other disposition (other than a redemption) of what was found to be § 306 stock, the Service cited Rev. Rul. 56-116, 1956-1 CUM. BULL. 164 (dealing with a proposed transaction). The facts, as set forth in Revenue Ruling 57-103, however, suggest that the "C" reorganization had been completed and a disposition of preferred shares planned at the time the Ruling was issued. Consider, however, a private ruling issued in 1963, prior to completion of a proposed "B" reorganization. A two bite approach was taken, but query whether the corporations involved were closely or publicly held. The ruling is cited in Berger & Kanter, *Shop Talk*, 18 J. TAXATION 252 (1963).

⁹⁹ The publicly held nature of the issuing corporation is suggested by the later ruling, the widely held nature of certain non-section 306 preferred shares is suggested by both the later ruling and Revenue Ruling 56-116, and the final proviso that non-

while Revenue Ruling 59-84,¹⁰⁰ and the obvious implications of part one of the suggested rule of thumb, suggest part two. Revenue Ruling 59-84 provides that preferred shares issued with respect to common by a closely held corporation will constitute section 306 stock if, after the transaction, the shareholders who receive preferred stock own a percentage interest in the common equity of the corporation which is greater than or not substantially less than their percentage interest prior to the transaction. Revenue Ruling 59-84, therefore, suggests that the shareholders of a closely held corporation initially must establish lack of equivalence to a dividend under the cash substitution test in order to avert the characterization of their preferred shares as section 306 stock.

The rule of thumb thus emerges from the three rulings discussed above, but the underlying reason for the rule is more difficult to ascertain. Certainly it is not true that widely held preferred shares issued by a publicly held corporation will not enable the holder to bail earnings and profits out of the enterprise without dilution of his existing equity position. I have concluded that it is the government's belief that section 306(b)(4) and the definitional provisions of section 306 of the Code must be read as a whole, so that the motive behind the issuance and/or disposition of preferred shares becomes relevant for purposes of determining their section 306 character. Section 306(b)(4) provides that the disposition of section 306 stock will not give rise to an ordinary income tax if a primary purpose behind the issuance and/or disposition of the stock was not the desire to avoid federal income taxes. Thus, preferred shares whose issuance and/or disposition were not prompted primarily by a desire to avoid federal income taxes could not be regarded as section 306 stock under the government's motive-oriented approach to the definition of section 306 stock. The fact that preferred shares are widely held, the fact that the issuing corporation is publicly rather than closely held and the fact that the shares will neither be redeemed nor sold in anticipation of redemption shortly after issuance, all suggest that avoidance of tax was not the motive for the issuance (and disposition) of the shares. Hence the suggested two-part rule of thumb follows.¹⁰¹

section 306 shares must, shortly after issuance, neither be redeemed nor sold in anticipation of redemption, is taken from Revenue Ruling 56-116, where the government in effect found non-section 306 stock, provided that the preferred shares in question would be sold only to a third party, other than in anticipation of redemption.

¹⁰⁰ 1959-1 CUM. BULL. 71. Consider also Rev. Rul. 66-332, 1966-2 CUM. BULL. 108, which may have involved a closely held corporation.

¹⁰¹ See DeWind, *Preferred Stock "Bail-Outs" and the Income Tax*, 62 HARV. L. REV. 1126, 1140 (1949); Kanter, *Preferred Stock in "B" Reorganization* 98-99. The relevance of motive under tax law is discussed in Brown, *An Approach to Subchapter C*, 3 TAX REVISION COMPENDIUM 1619, 1620 (1959).

Given this reason for the rule, further support for its existence can be found in a number of published revenue procedures (some of which have been superseded), dealing with whether a shareholder can avoid an ordinary income tax upon the disposition of his section 306 shares by reason of the exception set forth in section 306(b)(4). Revenue Procedure 64-31,¹⁰² published in 1964 and since expanded, provided that advance rulings would not be issued as to whether or not the distribution or disposition of section 306 stock in a closely held corporation was in pursuance of a plan having tax avoidance as one of its principal purposes. The phrase "in a closely-held corporation" was new to Revenue Procedure 64-31, for two years earlier Revenue Procedure 62-32¹⁰³ merely indicated that no advance rulings would be issued on the matter of tax avoidance. The addition of the phrase "closely-held corporation" suggested a willingness on the part of the government to issue rulings prior to a reorganization, which, in effect, indicated the non-section 306 character of certain widely held preferred shares to be issued by a publicly held corporation. The addition of this phrase further suggested the government's belief that preferred stock issued by a closely held corporation would constitute section 306 stock if the requirements of the cash substitution test could be met.

Section 5 of Revenue Procedure 66-34,¹⁰⁴ amplifying Revenue Procedure 64-31, further indicates the existence of the government's two-part rule of thumb suggested above. Revenue Procedure 66-34 provides that a ruling usually will be issued under section 306(b)(4) if (a) the stock (presumably section 306 stock) of the issuing corporation is widely held and either (b) the section 306 stock is not redeemable for at least five years from date of issuance and the taxpayer represents that there will be no redemption of the stock within the five-year period or (c) disposition of the stock is not by way of redemption or by way of sale in anticipation of redemption.¹⁰⁵ Certainly this procedure suggests that the government will issue pre-reorganization rulings which, in effect, indicate the non-section 306 status of widely held preferred shares (probably issued by a publicly held corporation), regardless of the existence or non-existence of dividend equivalence, provided that the shares, shortly after issuance, are neither redeemed nor sold in anticipation of redemption.

¹⁰² 1964-2 CUM. BULL. 947, 950-51.

¹⁰³ 1962-2 CUM. BULL. 527, 532, *superseding* Rev. Proc. 60-6, 1960-1 CUM. BULL. 880, 884. The provisions of both Procedures were identical.

¹⁰⁴ 1966-2 CUM. BULL. 1232, 1234.

¹⁰⁵ With respect to this latter alternative, the Procedure actually provides as follows:

A ruling will usually be issued under section 306(b)(4) of the Code to the effect that a distribution of "section 306 stock" (other than a distribution under section 305 of the Code) and the disposition of the "section 306 stock",

The various limitations in the procedure support this conclusion insofar as it relates to the conditions under which favorable section 306(b)(4) rulings will be issued. But the conclusion as to the government's willingness to issue pre-reorganization, definitional rulings is more difficult to support. The procedure does not explicitly indicate that such definitional rulings will be issued if the stated conditions are present. Indeed, the procedure assumes the existence of section 306 stock. But the procedure does not indicate that a disposition must be planned before the Treasury will issue a ruling under section 306(b)(4). Thus, the procedure enables the Treasury to continue to issue pre-reorganization rulings under section 306(b)(4). And by issuing such rulings, the government indicates its belief that the widely held preferred shares of a publicly held corporation do not constitute section 306 stock, if the conditions expressed in the rule of thumb can be met.

D. Conclusion

In order to ascertain whether or not convertible preferred stock issued in a corporate reorganization constitutes section 306 stock, one is compelled by the lack of direction in the Code, the regulations and the published revenue rulings and procedures to ask whether or not ordinary preferred stock issued under identical circumstances would constitute section 306 stock. The government appears to have adopted such an approach in Revenue Procedure 66-34, the first published procedure in which the government has demonstrated any awareness of the fact that convertible preferred stock is a commodity distinct from ordinary preferred.

In order to determine whether or not ordinary preferred stock would constitute section 306 stock had it been issued in place of convertible preferred, one initially must determine whether a pure or modified cash substitution test is to be applied. Given the fact that the most recent revenue ruling and revenue procedure which deal with section 306¹⁰⁶ appear to support a modified cash substitution test, the

other than by redemption and other than in anticipation of a redemption, is not pursuant to a plan of tax avoidance if the stock of the issuing corporation is widely held and

(a) the "section 306 stock" is by its terms redeemable within five years from the date of issuance, or

(b) the "section 306 stock" is not redeemable within five years from the date of issuance but the issuing corporation will not represent that there will be no redemption (as a result of a change in the terms of the stock, an invitation for tenders or otherwise) within five years from the date of issuance.

Id. at 1234-35.

¹⁰⁶ Rev. Rul. 60-1, 1960-1 CUM. BULL. 143; Rev. Proc. 66-34, § 5, 1966-2 CUM. BULL. 1232, 1234.

problem becomes one of applying the proper part of the two-part rule of thumb set forth above. If part two is applicable, the problems created by the pure cash substitution test must be resolved.

III. THE STATUTORY SCHEME: THE DISPOSITION OF CONVERTIBLE PREFERRED, SECTION 306 STOCK

The road to non-section 306 stock status, then, is filled with pitfalls and hurdles. But once section 306 stock status is ascertained, it is not a foregone conclusion that an ordinary income tax, as opposed to a capital gains tax, will be imposed upon disposition of section 306 shares. An analysis of the exceptions to section 306(a)(1) and (2)¹⁰⁷ suggests many ordinary circumstances under which convertible preferred, section 306 stock may be sold to a third party or to the issuing corporation, either before or after conversion, without giving rise to an ordinary income tax.¹⁰⁸ In order to explore the alternatives, let us assume that, as the result of a statutory merger, shareholder *A* receives in exchange for his common stock of Corporation *X* both common and convertible preferred stock of Corporation *Y*, the surviving entity. The book value of the common shares received, let us assume, is equal to the par value of the common shares surrendered, while the par value of the preferred shares received is equal to *A*'s ratable share of the accumulated earnings of Corporation *X* prior to the merger. Let us assume, finally, that the convertible preferred shares received by *A* are section 306 shares, and that their par value is equal to the book value of *A*'s newly received common stock.¹⁰⁹

A. Disposition by Way of Conversion and Sale

1. Sale of All Shares Prior to Conversion

If shareholder *A* sells all of his stock in the issuing corporation prior to conversion, he generally will be taxed at capital gains, as opposed to ordinary income rates. Section 306(b)(1)(A) provides that section 306(a) will not be applied to a disposition which is not a redemption, if the disposition terminates the entire stock interest of the shareholder in the corporation.

Several conditions are placed upon the disposition, however. First, the stock cannot be sold to the shareholder's spouse, children, grand-

¹⁰⁷ See notes 96 and 97 *supra*.

¹⁰⁸ It is clear that § 306(a) will not be applied if a shareholder gives his § 306 stock away. INT. REV. CODE OF 1954, § 306(b)(3); see Rev. Rul. 57-328, 1957-2 CUM. BULL. 229. Nor will § 306(a) be applied if § 306 stock is redeemed in a distribution in partial or complete liquidation. INT. REV. CODE OF 1954, § 306(b)(2). But these exceptions to § 306 are less useful exceptions to § 306(a) than §§ 306(b)(1) and 306(b)(4).

¹⁰⁹ Shareholder *A* is actually in the same position as the shareholder in the hypothetical case set forth at text accompanying note 32 *supra*.

children or parents. Second, section 306(a) will continue to apply if the shareholder's spouse, children, grandchildren or parents hold stock in the surviving corporation after the shareholder himself disposes of his shares, because section 306(b)(1)(A) requires application of the family attribution rules set forth in section 318(a)(1).¹¹⁰ Finally, the rules of section 318(a)(2)¹¹¹ with regard to attribution from partnerships, estates, trusts and corporations will be applied. Thus, A may be unable to establish, first, that he has sold his shares to a permissible buyer and, second, that he has terminated his entire stock interest in the surviving corporation.¹¹²

2. Conversion of Preferred Shares in Year One and Sale of All Shares in Year Two

If our hypothetical shareholder decides to convert his preferred shares in one year and then to sell all of his stock in the surviving corporation the following year, a new problem is created. Assuming for the moment that section 306 status survives conversion, section 306(b)(1)(A) will enable the shareholder to escape ordinary income treatment in the second year. But will there be an ordinary income tax upon conversion? The question is whether conversion constitutes a taxable event.

Arguably, conversion constitutes an "E" reorganization, in which event it could not give rise to taxation.¹¹³ The government, however, apparently feels that a conversion is something distinct from a recapitalization. The distinction is merely semantic, however, for in a special ruling issued in 1945, the government indicated that the conversion of preferred stock into common pursuant to a conversion privilege set forth in the share certificate resulted in no taxable income or deductible loss.¹¹⁴ Although neither citing precedent nor articulating

¹¹⁰ INT. REV. CODE OF 1954, § 318(a)(1). Section 306(b)(1)(A)(ii) states that the disposition must not be "directly or indirectly, to a person the ownership of whose stock would (under section 318(a)) be attributable to the shareholder . . .," while § 306(b)(1)(A)(iii) states that the disposition must terminate the shareholder's stock interest in the corporation, "(and for purposes of this clause, section 318(a) shall apply)."

¹¹¹ INT. REV. CODE OF 1954, § 318(a)(2).

¹¹² The relevant provisions of § 306(b)(1)(A) are set forth at note 110 *supra*. One author suggests that the § 318(a) attributees (including family attributees) sell their shares in the corporation so that the holder of § 306 stock will not be taxable at ordinary rates. Ponder, *Current uses for preferred stock in tax planning despite prohibitions of sec 306*, 4 J. TAXATION 277 (1956).

¹¹³ INT. REV. CODE OF 1954, § 368(a)(1)(E). An "E" reorganization is defined as a recapitalization.

¹¹⁴ Special Ruling dated February 23, 1945, cited in 4 CCH 1945 STAND. FED. TAX REP. ¶ 6151. A private ruling stating that there would be no tax upon conversion of the convertible preferred shares issued in connection with Union Oil Company's acquisition of Pure Oil Company, is cited in 4 CCH SINCLAIR-MURRAY CAP. CHANGES REP. P-345.

a rationale to support its position, the government undoubtedly relied upon a regulation promulgated under the Revenue Act of 1918, providing that conversion of a bond into stock pursuant to a conversion privilege contained in the bond does not result in the realization of profit or loss, "the transaction not being closed . . . until [the] stock is sold."¹¹⁵

Hence, conversion does not constitute a taxable event, and our hypothetical shareholder will not be taxed upon the exchange of shares in year one.

3. Conversion of Preferred in Year One and Sale of One-Half Common in Year Two

If our hypothetical shareholder converts his preferred shares in one year and, in the following year, sells one-half of his common stock in the surviving corporation, a problem arises whether the proceeds of the sale represent ordinary income under section 306, assuming that those shares sold were obtained by way of conversion.¹¹⁶ In other words, does section 306 characterization survive conversion?¹¹⁷

Section 306(e)(1)¹¹⁸ provides the answer:

If section 306 stock was issued with respect to common stock and later such section 306 stock is exchanged for common

¹¹⁵ Treas. Reg. 45, art. 1563 (1920). The Regulation was found to be applicable under the Revenue Acts of 1921, 1924, 1926 and 1936. *Mim.* 3156, II-2 CUM. BULL. 24 (1923); I.T. 2216, IV-2 CUM. BULL. 19 (1925); I.T. 2347, VI-1 CUM. BULL. 86 (1927); G.C.M. 18436, 1937-1 CUM. BULL. 101; *cf.* I.T. 3056, 1937-1 CUM. BULL. 101, where the bondholders of *M* corporation converted their bonds into common stock of *O* corporation pursuant to a conversion privilege. The conversion was held to be a taxable event.

If conversion were considered to be a taxable event, it is interesting to speculate as to how our hypothetical shareholder would be taxed. Arguably, any gain should be taxed at ordinary rates, in that the shareholder is disposing of his § 306 stock—the consideration being common stock rather than cash. On the other hand, preferred stock loses its § 306 character upon conversion. *See* text accompanying notes 116-19 *infra*. Would taxation of gain at ordinary rates be justified, then, particularly in view of the fact that conversion may mean no bailout?

¹¹⁶ This is a LIFO approach, which the government might take were it in fact true that § 306 characterization survives conversion.

¹¹⁷ Section 306(c)(1)(C) initially appears to be relevant to the problem. This section provides that stock the basis of which is determined by reference to the basis of § 306 stock, constitutes § 306 stock. Clearly the common shares received by *A* upon conversion in year one have the same basis as his old preferred stock, due to the fact that conversion represents a non-taxable event. Thus, it could be argued that one-half of *A*'s common shares following conversion do indeed constitute § 306 stock.

¹¹⁸ Section 306(e)(1) is a second exception to § 306(c)(1)(C). The first exception, § 306(c)(1)(B), provides that common stock received in a corporate reorganization cannot be characterized as § 306 stock, even if received in exchange for § 306 shares. In light of § 306(c)(1)(B), § 306(e)(1) would be superfluous, were it not for the fact that the government has never considered a conversion to be a form of corporate reorganization within the meaning of § 368(a) of the Code (*i.e.*, a recapitalization). *See* S. REP. NO. 1622, 83 Cong., 2d Sess. 245 (1954).

stock in the same corporation . . . , then . . . the common stock so received shall not be treated as section 306 stock¹¹⁹

Thus, section 306 stock status does not survive conversion and the sale of fifty per cent of *A*'s common shares, following conversion, could under no circumstances give rise to ordinary income.

4. Sale of All Preferred Shares Prior to Conversion

If our hypothetical shareholder sells all of his preferred shares prior to conversion, he can neither escape ordinary income taxation under the termination of interest exception to section 306(a) discussed above, nor can he assert that his stock has lost its section 306 character. Thus, section 306(b)(4)(A) becomes relevant to the problem. Section 306(b)(4)(A) provides that section 306(a) will not apply "if it is established to the satisfaction of the Secretary or his delegate . . . that the distribution, and the disposition or redemption . . . was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."¹²⁰ Thus, in order to avoid an ordinary income tax, our hypothetical shareholder must establish (a) that a principal purpose of the corporation in issuing his section 306 shares was not tax avoidance,¹²¹ and (b) that one of his principal motives in disposing of his section 306 shares was not the desire to avoid an ordinary income tax.¹²²

Due to the brevity and scarcity of rulings dealing with section 306(b)(4)(A), it is difficult to ascertain the criteria by which corporate purpose is to be judged. Apparently, the distribution of

¹¹⁹ Section 306(e)(1) might apply to a situation in which a corporation adds a conversion privilege after preferred shares have been issued, and the privilege is exercised. With respect to the addition of a conversion privilege, see DEL. CODE ANN. tit. 8, § 151(e) (1953); 11 W. FLETCHER, PRIVATE CORPORATIONS § 5306 (perm. ed. rev. 1958).

¹²⁰ The Secretary must be satisfied as to the non-existence of a tax avoidance device. Thus one commentator has suggested that the standards set by the Secretary are not reviewable in any court of law, including the Tax Court. Trimble, *Treatment of Preferred Stock Distributions* 358.

¹²¹ It may be difficult to separate corporate from shareholder purpose upon initial issuance of § 306 stock, particularly in the case of closely held corporations where the board of directors is apt to consist of a majority of the shareholders. Brown, Dooley & Egan, *Some Tax Consequences of Stock Redemptions and Partial Liquidations*, 38 CONN. B.J. 294, 310-11 n.83 (1964).

¹²² It is interesting to note that Judge Arundell, dissenting in *C.P. Chamberlin*, 18 T.C. 164, 181 (1952), stated that a shareholder's intent (at the time of his receipt of a preferred stock dividend) as to the disposition he would make of the dividend should be irrelevant to the question of taxability upon disposition. Arundell chose to focus upon the intent and action of the corporation at the time of distribution of the dividend stock. Presumably he also considered shareholder motive upon disposition to be irrelevant.

section 306 stock must serve some legitimate business purpose, other than that of enabling shareholders to avoid an ordinary income tax.¹²³ It would appear that a legitimate purpose will be presumed if the shares of the issuing corporation are widely or publicly held.¹²⁴ In other cases a legitimate business purpose must be specifically established. In the context of a reorganization, such a purpose could consist of a desire to limit the new shareholders' participation in the equity of the surviving or acquiring enterprise,¹²⁵ or of a desire to consummate a merger or acquisition by use of an attractive security. Thus, our hypothetical shareholder should be able to establish without difficulty a valid business purpose for issuance of his convertible securities.

In addition to establishing a valid business purpose for the issuance of his section 306 shares, our hypothetical shareholder apparently must establish, under the corporate purpose umbrella, the absence of an intention on the part of the issuing corporation to redeem his section 306 stock shortly after distribution under the terms of a short-term sinking fund program.¹²⁶ Most corporations that issue convertible preferred stock as part of a corporate reorganization do not expect to redeem the convertible shares shortly after distribution, except possibly pursuant to the terms of a long-term sinking fund program.¹²⁷ Thus our hypothetical shareholder should be able to meet the second criterion of the corporate purpose test.

¹²³ Rev. Rul. 56-116, 1956-1 CUM. BULL. 164; Rev. Rul. 57-103, 1957-1 CUM. BULL. 113. The business purpose test may have been derived from the Tax Court opinion in *Chamberlin*, 18 T.C. at 177-78. The Tax Court, in turn, relied upon its opinion in *Alice H. Bazley*, 4 T.C. 897 (1945), *aff'd*, 331 U.S. 737 (1947).

¹²⁴ Rev. Rul. 57-212, 1957-1 CUM. BULL. 114 and Rev. Proc. 66-34, § 5, 1966-2 CUM. BULL. 1232, 1234, suggest the validity of this conclusion. In Revenue Ruling 57-212, the Service held that preferred stock issued with respect to common in a statutory merger of two large publicly owned corporations would not be taxable under § 306(a) when sold, despite the existence of a long-term sinking fund program. Section 306(b) (4) (A) was cited, but no mention was made of a legitimate business purpose for issuance of the § 306 shares. Reference was made to Rev. Rul. 56-116, 1956-1 CUM. BULL. 164, however, and thus it can be assumed that the Service felt that there was a valid business purpose due to public or widespread ownership. Revenue Procedure 66-34 strengthens the conclusion as to when the government will assume a valid business purpose under § 306(b) (4) (A). Section 5 of the procedure indicates that a favorable ruling will be issued under § 306(b) (4) (A) if it is first established that the stock of the issuing corporation is widely held. (A second condition must also be met. See the discussion of the procedure at text accompanying notes 104-05 *supra*.)

¹²⁵ See Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

¹²⁶ Rev. Rul. 56-116, 1956-1 CUM. BULL. 164 and Rev. Rul. 57-212, 1957-1 CUM. BULL. 114 so indicate. See Berger & Kanter, *Shop Talk*, 18 J. TAXATION 252 (1963); Chapman, *Exemption of 306 Stock* 222-23. See also Rev. Proc. 66-34, § 5, 1966-2 CUM. BULL. 1232, 1234.

¹²⁷ As the introduction indicates, acquiring corporations which today are issuing convertibles are doing so in order to insure a desired acquisition.

There remains the task of establishing the lack of an improper motive for the disposition of his section 306 shares.¹²⁸ If he is a minority shareholder in the merged corporation, there should be no difficulty. The Senate Report¹²⁹ specifically provides that section 306(b)(4)(A) applies to "isolated dispositions of section 306 stock by minority shareholders who do not in the aggregate have control of the distributing corporation." The report assumes that a minority shareholder's principal motives in disposing of section 306 stock do not include the desire to avoid federal income tax.¹³⁰

If our hypothetical shareholder is not a minority shareholder, no problems should arise if his section 306 shares are sold other than in anticipation of their redemption pursuant to the terms of a short-term sinking fund program established by the surviving corporation. As Part I of this paper indicates,¹³¹ the enactment of section 306 was prompted by the *Chamberlin* tax avoidance device, whereby preferred shares were issued pro rata to common shareholders who subsequently sold the shares (incurring only a capital gains tax) with the realization that the shares would be redeemed over a relatively short period of time pursuant to the operation of an established, short-term redemption program. Thus, sale of section 306 shares in anticipation of redemption pursuant to the terms of an established short-term sinking fund program clearly would suggest a tax avoidance motive for the disposition of the section 306 shares, particularly in view of the fact that redemption in the hands of the original shareholder would give rise to an ordinary income, as opposed to a capital gains tax. Conversely, the absence of shareholder anticipation of redemption pursuant to the terms of a short-term sinking fund program would tend strongly to suggest the absence of tax avoidance as a motivating force behind the disposition.

An intention to dispose systematically of all of one's shares in the surviving corporation would also tend to suggest the absence of tax avoidance as a motivating force behind the disposition of section 306 shares.¹³² Thus, if our hypothetical shareholder is not a minority

¹²⁸ Rev. Proc. 66-34, § 5, 1966-2 CUM. BULL. 1232, 1234, suggests the irrelevance of shareholder motives. But the word "usually" which appears twice in § 5 of the procedure will permit the government to consider shareholder motive, as it has in the past.

¹²⁹ S. REP. NO. 1622, 83d Cong., 2d Sess. 243-44 (1954).

¹³⁰ A shareholder's former holdings in the acquired corporation would appear to the Senate to be irrelevant, although query whether such holdings should be irrelevant. A minority shareholder who owned most of the shares of the acquired enterprise could have demanded the issuance of convertible stock, due to his desire to avoid an ordinary income tax. And the issuing corporation, due solely to its desire to acquire the closely held enterprise, could have acquiesced.

¹³¹ See text accompanying notes 12-29 *supra*.

¹³² Rev. Rul. 56-223, 1956-1 CUM. BULL. 162 involved a situation in which the § 306 and common shares of retiring employees were to be purchased by the employer's

shareholder, and if a short-term sinking fund program does exist, the shareholder may be able to meet the motive-upon-disposition requirement of section 306(b)(4)(A) by establishing that he intends to dispose of all of his shares in the surviving corporation over a short period of time.

No other means of establishing a valid shareholder motive appear to exist. Thus, under certain circumstances, our hypothetical shareholder will be unable to meet at least one of the two requirements which must be met before section 306(b)(4)(A) can be applied. In such case, his entire gain or a portion thereof will be taxable at ordinary rates.

5. Sale of a Pro-Rata Portion of Common and Preferred Prior to Conversion

If section 306(b)(4)(A) is inapplicable because of *A*'s principal desire to avoid an ordinary income tax upon disposition of his section 306 shares, *A* can escape section 306(a) treatment only by converting some of his preferred shares prior to sale, or by selling his entire stock interest in the issuing corporation. But if the inapplicability of section 306(b)(4)(A) is posited on the grounds of corporate purpose alone, an additional "out" remains.¹³³ Section 306(b)(4)(B) provides that section 306(a) will not apply in the case of the disposition of section 306 stock and a prior or simultaneous disposition of the stock with respect to which the section 306 stock was issued, "if it is established to the satisfaction of the Secretary or his delegate . . . that the disposition . . . of the section 306 stock . . . was not in pursuance of a plan having" tax avoidance as one of its principal purposes. This section would appear to permit our hypothetical shareholder to dispose "safely" of a portion of his section 306 shares, given a prior or simultaneous disposition of the common stock with respect to which these shares were issued.¹³⁴

However, the Senate Report and the regulations¹³⁵ cast doubt upon this interpretation. The illustration of section 306(b)(4)(B) set forth

qualified profit sharing trust over a six-year period. The Service held that the disposition was not in pursuance of a plan having as one of its principal motives the avoidance of federal income tax. See Trimble's comment on the ruling, Trimble, *Treatment of Preferred Stock Distribution* 359-62.

¹³³ Section 306(b)(4)(A) may be our hypothetical shareholder's only "out" if he wishes to retain his common stock in the issuing corporation and if he is unable to convert his § 306 shares due to the expiration of the conversion privilege.

¹³⁴ Note that only the disposition need be for reasons other than tax avoidance. See SECTION 306 STOCK, TAX MANAGEMENT PORTFOLIO No. 85, at 48 (1963); Cohen, Silverman, Surrey, Tarleau & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 409 n.113 (1955).

¹³⁵ S. REP. No. 1622, 83 Cong., 2d Sess. 244 (1954); Treas. Reg. § 1.306-2(b)(3) (1960).

in the Senate Report and in the regulations suggests that section 306(b)(4)(B) is to apply only to the complete termination of a shareholder's interest in the issuing corporation. The example indicates that if a shareholder owns 100 shares of common stock, receives 100 shares of section 306 stock and sells the common first, sale of the section 306 stock will not give rise to ordinary income.

The example has been criticized by many commentators,¹³⁶ and rightly so in view of the fact that, given section 306(b)(1), the example appears to render section 306(b)(4)(B) superfluous. Although it could be argued that section 306(b)(4)(B) was added to cover cases of the complete termination of a shareholder's interest falling outside the protection of section 306(b)(1), due either to the attribution rules¹³⁷ or to section 306(b)(1)'s inapplicability to a multi-step termination of a shareholder's interest in the issuing corporation,¹³⁸ such explanations are unsound. To accept the explanation derived from the relevance of the attribution rules would be to render section 306(b)(1)'s reference to section 318(a) meaningless, and to read section 306(b)(1) so that it encompasses only one-step dispositions of a shareholder's entire stock interest in the issuing corporation would be to narrow, without justification, the coverage of section 306(b)(1).

There is no need to apply section 306(a) if a shareholder holds no stock in the issuing corporation after the disposition of his section 306 shares, despite the fact that some of his shares in the issuing corporation were sold prior to the terminating transaction. A bailout cannot occur as the result of a terminating transaction, and thus a definite rule setting forth the inapplicability of section 306(a) is warranted. Realizing this, Congress enacted section 306(b)(1).

The example set forth in the Senate Report and the regulations, then, does not indicate the scope of section 306(b)(4)(B). Section 306(b)(4)(B) must have independent significance, and if it is to have such significance, it must be interpreted to cover pro rata dispositions of section 306 and underlying common stock.¹³⁹ Thus, if Corporation *W* issues preferred, section 306 shares to its common shareholders, and if, thereafter, shareholder *S* disposes of one-half of

¹³⁶ E.g., Bittker, *Stock Dividends, Distributions in Kind, Redemptions and Liquidations Under the 1954 Code*, U. So. CAL. 1955 TAX INST. 349, 401; Trimble, *Treatment of Preferred Stock Distributions* 359.

¹³⁷ See Alexander & Landis, *Bail-Outs* 950; Bittker, *supra* note 136, at 401; Trimble, *Treatment of Preferred Stock Distributions* 359 n.65.

¹³⁸ See Bittker, *supra* note 136, at 401-02.

¹³⁹ SECTION 306 STOCK, TAX MANAGEMENT PORTFOLIO No. 85, at 47 (1963); Bittker, *supra* note 136, at 402; Lanahan, *Stock Dividends and Section 306 Stock*, MARQ. U. 5TH INST. ON FED. TAX. 65, 86 (1954); Schwaighart, *Despite 306, preferred stock is still very useful in corporate tax planning*, 14 J. TAXATION 348, 349 (1961).

his common stock and one-half of his newly issued preferred, he will be taxable at capital gain rates under the provisions of section 306(b)(4)(B), if he can establish to the satisfaction of the Secretary that the disposition of his shares was not in pursuance of a plan having tax avoidance as one of its principal purposes. (If all common shareholders of Corporation *W* acted in the same manner as *S*, there would be an obvious bailout, so that *S* probably could not establish lack of tax avoidance to the Secretary's satisfaction.)

An additional problem, not present in ordinary stock dividend situations, is raised with respect to shareholders who receive section 306 stock in a corporate reorganization. As to such shareholders, what stock constitutes the underlying common stock? Underlying common stock in such cases should constitute the common shares of the acquiring corporation which represent the common stock interest that the shareholders gave up in the acquired enterprise. Under this definition, the common shares received by *A* in the hypothetical corporate reorganization would constitute underlying common stock. And thus *A* might sell the same portion of his common and section 306 stock prior to conversion without incurring an ordinary income tax, provided that he can establish to the Secretary's satisfaction that the disposition was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax. Further, the disposition of preferred and common stock need not be simultaneous, provided that the common shares are disposed of first.

6. Summary

To summarize, then, the following means of escaping section 306(a)(1) treatment exist:

(a) A shareholder may sell all of his stock in the issuing corporation, provided that he sells to the proper individuals and provided that shares held by others in the issuing corporation cannot be attributed to him. (Section 306(b)(1)(A).)

(b) A shareholder may convert his section 306 stock into common and, at any time thereafter, sell one or more of the common shares. (Section 306(e)(1).)

(c) A shareholder may sell some of his convertible preferred shares prior to conversion provided that he is able to establish both a valid corporate purpose for issuance of the convertible stock and the fact that one of his principal motives in disposing of his section 306 shares was not the desire to avoid an ordinary income tax. (Section 306(b)(4)(A).)

(d) Finally, a shareholder may sell the same portion of his section 306 and underlying common shares (simultaneously or the common first), provided that a principal motive for disposition of the shares does not constitute tax avoidance. (Section 306(b)(4)(B).)

B. Disposition by Way of Conversion and Redemption

All of our hypothetical shareholder's section 306 stock need not be sold to a third party under the circumstances described above in order to enable him to escape an ordinary income tax. Because of the provisions of section 306(b) which deal with redemption, the shareholder, under specific circumstances, may escape a penalty by "sale" to the issuing corporation as well.¹⁴⁰

1. Redemption of All Shares

If the issuing corporation redeems all of the shareholder's stock in the corporation, section 306(b)(1)(B) will generally permit him to escape an ordinary income tax. Section 306(b)(1)(B) provides that subsection (a) will not apply if the disposition is by way of redemption and if section 302(b)(3) applies. Section 302(b)(3), in turn, provides that a capital gains tax will be imposed "if the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder."

A problem does arise, however, in view of the fact that, under certain circumstances set forth in section 302(c)(2), the family attribution rules of section 318(a)(1) must be applied to a distribution described in section 302(b)(3).¹⁴¹ Further, the rules concerning attribution from partnerships, estates, trusts and corporations must be applied under section 302(b)(3) in order to determine whether or not a redemption terminates a shareholder's entire equity interest in the corporation. Presumably, Congress felt that these limitations upon section 302(b)(3) would be applied when reference was made to section 302(b)(3) pursuant to the provisions of section 306(b)(1)(B).¹⁴²

¹⁴⁰ This section will not consider partial liquidations.

¹⁴¹ The family attribution rules must be applied: (1) if, given a tax avoidance motive, any portion of the stock redeemed was acquired within the ten-year period ending on the date of the distribution by the distributee from a person the ownership of whose stock would be attributable, to the distributee at the time of the distribution; (2) if, given a tax avoidance motive any person owns, at the time of the distribution, stock the ownership of which is attributable to the distributee and such person acquired any stock in the corporation from the distributee within the ten-year period ending on the date of the distribution; or (3) if the distributee acquires an interest in the redeeming corporation within ten years from the date of the distribution.

¹⁴² See Dauber, *Beware these two "loopholes" to get preferred-stock bailout under 1954 Code*, 2 J. TAXATION 75, 77 (1955); cf. Ponder, *supra* note 112, at 278; Schwaighart, *supra* note 139, at 348.

Thus, under certain circumstances, our hypothetical shareholder will be taxed under section 306(a), despite the fact that all shares held personally by him are redeemed by the issuing corporation.

2. Conversion of Preferred and Redemption Thereafter of the Former Preferred

If our hypothetical shareholder converts his section 306 stock, there will be no tax upon conversion.¹⁴³ Nor will the shares retain their section 306 character.¹⁴⁴ Thus, upon redemption of his former section 306 shares, taxability will depend upon the provisions of section 302. Only if the redemption is (a) in complete termination of the shareholder's interest in the corporation,¹⁴⁵ (b) substantially disproportionate¹⁴⁶ or (c) not essentially equivalent to a dividend,¹⁴⁷ will the capital gain provisions of the Code be applied; otherwise, there will be ordinary income.

3. Redemption of All Preferred Stock Prior to Conversion

If our hypothetical shareholder elects not to convert his section 306 stock, and if the issuing corporation decides to redeem the shares, the shareholder will be forced to turn to section 306(b)(4)(A) for relief from section 306(a) treatment. Section 306(b)(4)(A) deals not only with dispositions by way of sale to third parties, but also with redemptions. Thus, if the shareholder can establish to the satisfaction of the Secretary or his delegate that both the distribution and redemption of section 306 stock were not in pursuance of a plan having tax avoidance as a principal purpose, section 306(a) will not be applied.

As in the case of a sale of section 306 stock, the shareholder must establish that a principal corporate purpose for the distribution of section 306 stock was not the avoidance of federal income taxes.¹⁴⁸ But to establish that the redemption itself was not in pursuance of a plan having tax avoidance as one of its principal purposes, the shareholder must produce evidence of a non-tax avoidance corporate—as opposed to shareholder—purpose for the redemption, because it is the corporation rather than the shareholder that is ultimately responsible for the redemption. As a practical matter, however, shareholder purpose, particularly if the corporation is closely held, will become crucial.¹⁴⁹

¹⁴³ See text accompanying notes 113-15 *supra*.

¹⁴⁴ See text accompanying notes 116-19 *supra*.

¹⁴⁵ INT. REV. CODE OF 1954, § 302(b)(3).

¹⁴⁶ *Id.* § 302(b)(2).

¹⁴⁷ *Id.* § 302(b)(1).

¹⁴⁸ See text accompanying notes 120-27 *supra*.

¹⁴⁹ See Brown, Dooley & Egan, *supra* note 121.

Published revenue rulings suggest only one corporate purpose for the redemption of section 306 stock which can withstand attack under section 306(b)(4)(A): adherence to the terms of a long-term sinking fund program.¹⁵⁰ Other non-tax oriented corporate motives for the redemption of section 306 stock undoubtedly exist, however, and thus each case must be judged individually.¹⁵¹

But assuming that the requirements of section 306(b)(4)(A) can be met, our hypothetical shareholder is not home free. Redemptions are specifically covered by section 302 and, under current law, redemptions of section 306 stock must be tested under section 302 once the inapplicability of section 306(a) is established by reason of section 306(b)(4)(A).¹⁵² Thus, pursuant to the terms of section 302(d), the provisions of section 301 will be applied so that our hypothetical shareholder will be taxable at ordinary rates upon the disposition of his section 306 shares, unless one of the three exceptions to section 302(d) does in fact apply.¹⁵³ In the case of our hypothetical shareholder, as in most instances, proof will be required that "the redemption [was] not essentially equivalent to a dividend."¹⁵⁴

¹⁵⁰ Rev. Rul. 57-212, 1957-1 CUM. BULL. 114; see Kanter, *Preferred Stock in "B" Reorganization* 99.

¹⁵¹ The Service apparently will not issue rulings on the applicability of § 306(b)(4)(A) to redemptions until a redemption is planned, unless the § 306 shares in question cannot and will not be redeemed within five years from issuance. Rev. Proc. 66-34, § 5, 1966-2 CUM. BULL. 1232, at 1234.

For a discussion of the Service's policy with respect to redemption rulings under § 306(b)(4)(A) prior to August of 1966, see Berger & Kanter, *Shop Talk*, 18 J. TAXATION 252 (1963); Chapman, *Exemption of 306 Stock* 221.

¹⁵² See SECTION 306 STOCK, TAX MANAGEMENT PORTFOLIO No. 85, at 50-51. Rev. Rul. 56-654, 1956-2 CUM. BULL. 216, specifically indicates that upon the redemption of possible § 306 shares, reference should be made to both §§ 302 and 306 of the Code. Cf. Rev. Rul. 57-212, 1957-1 CUM. BULL. 114, where § 306(a)(2) was found to be inapplicable, but no mention was made of the relevance of § 302.

¹⁵³ An argument could be made that once § 306 stock is posited, and once § 306(a) is found to be inapplicable due solely to § 306(b)(4)(A), the inquiry should terminate. The fact that the draftsmen of § 306 specifically referred to § 302 in § 306(b)(1)(B) suggests that § 302 would be inapplicable absent such reference. Further, it is arguable that reference to § 302 after the requirements of § 306(b)(4)(A) have been met would lead to results inconsistent with the statutory scheme. In many, if not most, cases, a shareholder whose § 306 stock is redeemed will be unable to meet the substantially disproportionate redemption requirements of § 302(b)(2). Thus, if § 302 is to be applied, the requirements of § 302(b)(1) must be met for a shareholder to escape an ordinary income tax. But § 302(b)(1) sets forth a dividend equivalence test which no shareholder holding § 306 stock should be able to meet. This is because a net effect test based upon the net effect test which evolved under the predecessor of § 302(b)(1) will be applied in determining the presence or absence of § 306 stock under all the dividend equivalence tests which can be applied under § 306(c)(1)(B), given the inapplicability of the *Bedford* doctrine under a pure cash substitution test. If the *Bedford* doctrine were applied, dividend equivalence could be found despite the impact of the net effect test developed under § 302(b)(1). Thus, if § 302 must be applied after the requirements of § 306(b)(4)(A) have been met, it is arguable that reference to redemptions in § 302(b)(4)(A) becomes meaningless.

Two problems are created by this analysis, however. First, a business purpose test, in addition to a net effect test, can be applied under § 302(b)(1) as well as under § 306(b)(4)(A), so that arguably, if § 306(b)(4)(A) is found to be applicable, the shareholder can escape an ordinary income tax under § 302(b)(1) as well. (S. REP. No. 1622, 83d Cong., 2d Sess. 234 (1954), indicates that the tests developed under

4. Redemption of One-Half Common and One-Half Preferred Prior to Conversion

If the issuing corporation redeems one-half of our hypothetical shareholder's preferred shares, simultaneously with or following a redemption of the common shares with respect to which these preferred shares were issued, section 306(b)(4)(B) will enable him to escape section 306(a) treatment as to the preferred shares provided that he can establish to the satisfaction of the Secretary or his delegate that the redemption of section 306 stock was not in pursuance of a plan having tax avoidance as one of its principal purposes.¹⁵⁵ But again, shareholder *A* will be home free only if he can establish that, pursuant to the terms of section 302(b)(1), "the redemption [was] not essentially equivalent to a dividend," or that, pursuant to the terms of section 302(b)(2), the redemption was "substantially disproportionate."

5. Summary

To summarize, then, the redemption of convertible preferred, section 306 shares will give rise to a capital gains, as opposed to an ordinary income tax:

§ 115(g)(1) of the 1939 Code should be applied in interpreting § 302(b)(1). Under the 1939 Code, several courts developed a business purpose test. *See, e.g.,* Phelps v. Commissioner, 247 F.2d 156 (9th Cir. 1957). Under the present Code, the Tax Court and Court of Claims have referred to business purpose. *Neff v. United States*, 305 F.2d 455 (Ct. Cl. 1962); *Thomas J. Lewis*, 35 T.C. 71 (1960). And the government will not disregard business purpose, although emphasis will be placed upon net effect. Rev. Rul. 55-515, 1955-2 CUM. BULL. 222; Rev. Rul. 56-103, 1956-1 CUM. BULL. 159; Rev. Rul. 56-521, 1956-2 CUM. BULL. 174; Rev. Rul. 57-353, 1957-2 CUM. BULL. 223.)

Even accepting the fact that a business purpose test can be applied under § 302(b)(1), however, it is clear that some courts will disregard business purpose. Under the 1939 Code the Second and Third Circuits looked only to net effect. *Northup v. United States*, 240 F.2d 304 (2d Cir. 1957); *Kessner v. Commissioner*, 248 F.2d 943 (3d Cir. 1957). *But see* the discussion in *Ballenger v. United States*, 301 F.2d 192, 197-98 (4th Cir. 1962). And those courts which will apply a business purpose test will also consider net effect. Research has revealed only two cases in which an essentially pro rata redemption was not treated as a dividend because of what the court considered to be an overriding corporate business purpose. *Davis v. United States*, 274 F. Supp. 466 (M.D. Tenn. 1967); *Keefe v. Cote*, 213 F.2d 651 (1st Cir. 1954); *see Ballenger v. United States, supra* at 197-98.

Thus, the existence of a business purpose test does not substantially undermine the theory expressed at the outset of this note. But the second problem created by the analysis does. Although the same net effect tests will generally be applied under §§ 302(b)(1) and 306(c)(1)(B), given the inapplicability of the *Bedford* doctrine, the tests will be applied at different times, so that the results need not be the same. Thus, it is not clear that § 302(b)(1) sets forth a dividend equivalence test which even most shareholders holding § 306 stock should be unable to meet.

¹⁵⁴ INT. REV. CODE OF 1954, § 302(b)(1). In most cases, the redemption will not be substantially disproportionate, *id.* § 302(b)(2), and the example assumes that *A* retains his common stock so that the redemption will not be in complete termination of his equity interest in the corporation. *Id.* § 302(b)(3).

¹⁵⁵ *See* Bittker, *supra* note 136, at 402, and the discussion of § 306(b)(4)(B), at text accompanying notes 148-51 *supra*.

(a) if the redemption is in complete termination of the shareholder's equity interest in the issuing corporation (sections 306(b)(1)(B) and 302(b)(3));

(b) if the shares are actually converted prior to redemption and the requirements of section 302(b)(1), (2) or (3) can be met;

(c) (i) if it can be established to the satisfaction of the Secretary that the distribution and redemption of the shares were not in pursuance of a plan having tax avoidance as one of its principal purposes (section 306(b)(4)(A)), and (ii) if the requirements of section 302(b)(1) can be met; or

(d) (i) if the common shares, with respect to which the convertible shares were issued, are simultaneously redeemed (or were previously redeemed), (ii) if it can be established to the satisfaction of the Secretary that the redemption of section 306 stock was not in pursuance of a plan having tax avoidance as one of its principal purposes (section 306(b)(4)(B)), and (iii) if the requirements of section 302(b)(1) or (2) can be met.

IV. SUGGESTED REVISIONS IN THE LAW

Although convertible redeemable preferred shares have become popular primarily for business reasons, their popularity has been caused in part by the fact that shareholders of corporations to be acquired do not believe that convertible preferred shares will be regarded, or taxed upon disposition, as section 306 stock. Analysis of the Code, the regulations and the published rulings and revenue procedures indicates the validity of this conclusion. Although it may be difficult to establish the non-section 306 status of convertible preferred shares issued in a corporate reorganization, the holder of convertible preferred, section 306 stock can dispose of his section 306 shares so as to avoid an ordinary income tax without great inconvenience.

Because there are many situations in which the issuance of convertible preferred stock as part of a corporate reorganization will not enable shareholders to bail earnings and profits out of an enterprise without diluting their existing equity position, the fact that shareholders of an acquired corporation can safely assume that such stock will not constitute or will not be taxed upon disposition as section 306 stock is not intolerable. But there are several ways in which the law might be revised so that results more consistent with the purpose of section 306 might be achieved on a uniform basis.

A. Suggested Regulations

First, the Treasury should issue a regulation to the effect that convertible preferred stock must be treated as ordinary preferred for

the purpose of determining its section 306 character. Because it is impossible to determine at the outset whether or not convertible preferred stock will be converted, and thus whether or not its bailout potential will be eliminated, convertible preferred shares initially should be regarded as ordinary preferred. The Treasury will apparently treat all convertible preferred as ordinary preferred,¹⁵⁶ but a regulation requiring the Service to do so would be helpful in achieving proper and consistent results.

In addition, a regulation revamping the current cash substitution test should be issued. All references to section 356 in the current test should be eliminated so that a revised cash substitution test might read as follows:

Ordinarily, section 306 stock includes stock which is not common stock received in pursuance of a plan of reorganization (within the meaning of section 368(a)) or received in a distribution or exchange to which section 355 (or so much of section 356 as relates to section 355) applies if cash received in lieu of such stock would have been treated as a distribution to which section 301 applies by virtue of section 302(d) or otherwise.¹⁵⁷

Such a test would eliminate the various questions which have been raised by a section 356-oriented cash substitution test: the applicability of the *Bedford* doctrine; the relevance of the dividend-within-gain rule; and the impact of hypothetical cash upon the continuing qualification of the underlying transaction as a tax-free exchange and thus upon the continuing applicability of section 356. The elimination of these problems would permit concentration upon the essential question raised by section 306(c)(1)(B)(ii)—the “net effect” of the transaction.

A revised cash substitution test should be coupled with a statement indicating that newly issued convertible preferred or preferred shares cannot be excluded from the category of section 306 because of:

1. The publicly held nature of the issuing corporation and the fact that the shares are widely held; or
2. The fact that the shares were not issued in pursuance of a tax avoidance scheme.

¹⁵⁶ See the discussion of Rev. Proc. 66-34, § 4, at text accompanying notes 55-59 *supra*.

¹⁵⁷ In eliminating the reference to § 356, I have no difficulty with the fact that in a reorganization context, the taxability of “boot” is dependent upon the provisions of § 356. The cash substitution test creates a hypothetical situation by substituting hypothetical cash for what might be § 306 stock. The cash substitution test can thus go further and assume that even in a reorganization context, hypothetical cash must be judged, for purposes of § 306, under the net effect criteria of § 302, rather than under the dividend equivalence test of § 356.

Such a statement would appear to contradict the government's current practice,¹⁵⁸ but would clearly be in line with the purpose of section 306. A bailout of earnings and profits may occur by means of the issuance of additional shares of stock, despite the non-tax avoidance motives of the issuing corporation and its shareholders, and despite the publicly held nature of the issuing corporation and the widely held nature of its newly issued shares.

B. Suggested Changes in the Statute

In addition to issuance of the suggested regulations, two major changes—each concerning the disposition of section 306 stock—should be made in section 306 itself. First, an exception to section 306(a) should be added to section 306(b), permitting the holder of convertible preferred section 306 stock to sell his stock (to the issuing corporation or to a third party) prior to conversion without incurring an ordinary income tax under section 306 if he can establish (in the event that his and other convertible shares were issued as part of a corporate reorganization to the shareholders of an acquired corporation) that over fifty per cent of the convertible shares issued to shareholders of the acquired corporation were converted prior to his sale, or (in the event that he received his convertible shares as an ordinary stock dividend) that over fifty per cent of the issued dividend shares were converted prior to his sale. As a practical matter, such a provision will aid only shareholders of a closely held corporation. But as to such shareholders, it will take into account the fact that conversion, prior to the sale, by shareholders other than the selling shareholder, will adversely affect the selling shareholder's equity interest in the enterprise. If shareholders holding less than fifty per cent of the outstanding convertible shares convert prior to the sale, the adverse effect will be negligible, but if shareholders holding over fifty per cent of the outstanding convertible shares convert prior to the sale, the effect will be sufficiently adverse to permit the conclusion that the sale of convertible preferred by one shareholder prior to conversion could not give rise to a classic bailout of earnings and profits.

In addition, subsection (b) (4) of section 306 should be eliminated. Just as motive should be irrelevant for purposes of determining the section 306 status of preferred or convertible preferred stock, so should motive be irrelevant for purposes of determining the manner in which section 306 stock is to be taxed upon disposition. As this article has repeatedly suggested, a bailout of earnings and profits may occur

¹⁵⁸ See the discussion of the suggested two part rule of thumb, at text accompanying notes 91-105 *supra*.

despite the motives of a corporation or its shareholders upon the distribution or disposition of section 306 stock.

C. Conclusion

Adoption of the changes outlined above would surely reduce the popularity of convertible preferred (and ordinary preferred) as a vehicle for mergers and acquisitions. Convertible preferred would more frequently be regarded as section 306 stock, while the provisions of section 306(a) would more frequently be applied upon disposition of the shares. But the suggested changes would lead to results more consistent with the purpose of section 306—to discourage preferred stock bailouts.