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CASE COMMENTS

Taxation — "Section 306 Stock"

Taxpayer, Eugene Fireoved,[1] incorporated Fireoved and Company, Inc., in 1948. He controlled Fireoved by virtue of his ownership of all one hundred shares of the corporation's voting common stock. Taxpayer also owned sixty-five shares of preferred stock. In 1954, Girard Business Forms, a two-man partnership owned by Karl Edelmayer and Kenneth Craver, was merged with taxpayer's corporation, and the new corporation adopted the name Girard Business Forms. The amount of voting common stock was increased from one hundred to three hundred shares, with Edelmayer and Craver each receiving one hundred shares to provide for equal voting power. In addition, the corporate by-laws were amended to require unanimous consent of the directors for corporate action and a vote of seventy-six percent of the outstanding common stock or unanimous consent of the directors to amend the by-laws. Non-voting preferred stock was issued to reflect the capital investment of each man. Since the taxpayer's corporation had a net worth of approximately $60,000, the taxpayer was granted a stock dividend of 535 shares of preferred stock. This dividend, when added to the sixty-five preferred shares he already owned, gave him six hundred non-voting preferred shares worth $60,000. In 1958, the taxpayer sold twenty-four percent of his common stock to Edelmayer. This transaction left the taxpayer with 25⅓ percent of the corporation's outstanding stock, enough to maintain his position on the board of directors and to prevent amendment of the by-laws without his consent. In 1959, the company redeemed 451 of the taxpayer's 600 preferred shares at $105 each. The Commissioner, pursuant to section 306 of the Internal Revenue Code of 1954,[2] assessed a deficiency against the taxpayer, contending that the proceeds from the redemption should have been reported as ordinary

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[1] Taxpayer's wife was included in the suit only because they filed a joint federal income tax return.

[2] B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 10.02 (3d ed. 1971).

> [Section 306 of the 1954 Code creates] a new category of stock — "section 306 stock" — whose sale or other disposition will usually give rise to ordinary income rather than capital gain. Section 306 consists of (a) a definition of "section 306 stock"; (b) a set of rules providing that the sale or other disposition of "section 306 stock" will produce ordinary income rather than capital gain; and (c) a series of exceptions to these punitive rules.

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income.[3] Taxpayer paid the assessment and filed for a refund, which the Commissioner denied. Taxpayer then instituted suit in federal district court. The district court found that the 535 shares of preferred stock issued to taxpayer as a dividend were "section 306 stock" and proceeds therefrom were taxable as ordinary income. The court held, however, that twenty-four percent of the stock should not be taxed as "section 306 stock" because twenty-four percent of its underlying common stock had been sold prior to the redemption.[4] Both parties appealed this decision. *Held*, affirmed in part, reversed in part, and remanded. The 535 shares of preferred stock were "section 306 stock," and any proceeds realized therefrom were taxable as ordinary income. The sale of twenty-four percent of taxpayer's common stock prior to redemption did not remove the "section 306 stock taint" from twenty-four percent of the preferred stock. *Fireoved v. United States*, 462 F.2d 1281 (3d Cir. 1972).

The device by which the taxpayer attempted to withdraw the accumulated earnings and profits from his company as capital gains is known as a "preferred stock bailout." If a corporation distributes cash dividends, the dividends will be taxed as ordinary income. However, prior to enactment of section 306, if a corporation made a tax-free distribution of preferred stock, the shareholders could sell their stock and treat the proceeds as capital gain. Since the preferred stock normally had no voting power, the shareholders could in effect withdraw the corporate earnings and profits at capital gain rates without diluting their control of the corporation. The classic example of a "preferred stock bailout" is *Chamberlin v. Commissioner*.[5] In *Chamberlin*, a closely held corporation had assets of about $2.5 million of which approximately $1.3 million were in cash and United States Government securities. The corporation declared a tax-free stock dividend of 1⅓ shares of newly authorized preferred stock for each outstanding common share. Subsequently, the shareholders sold their dividend shares to an insurance company pursuant to an agreement negotiated

[3] The entire amount realized from the redemption of "section 306 stock" is treated as receipt of a dividend. Fireoved and Company, Inc., redeemed 451 shares of "306 stock." The "306 stock" had a basis of $100 per share and was redeemed at $105 per share by the company. The total receipt from the redemption was $47,355, which was an increase of $2,255 over the stock's basis of $45,100. Under section 306, however, the entire amount realized from the redemption, not just the gain above the basis, is taxed as a dividend under sections 301 and 316. Therefore, the tax deficiency was calculated with respect to the entire $47,355 received. [References are to Int. Rev. Code of 1954 unless otherwise noted.]

[4] 318 F. Supp. 133 (E.D. Pa. 1970).

[5] 207 F.2d 462 (6th Cir. 1953).

before the stock dividend was declared. The taxpayers treated the gain from this sale as capital gain. The Commissioner treated it as ordinary income. The tax court agreed with the Commissioner.[6] The circuit court reversed,[7] and certiorari was denied by the Supreme Court.[8] This presented the danger that all a taxpayer had to do to avoid having a dividend taxed as ordinary income was to get the dividend in stock and then sell it.

When *Chamberlin* was decided, Congress was in the process of drafting the Internal Revenue Code of 1954. In response it enacted section 306, which is designed to prevent the "preferred stock bail-out." Section 306 creates a new type of stock, the proceeds from which are treated as ordinary income. Section 306(c)(1) defines "306 stock" as stock falling into one of three categories: (1) tax free share dividend stock, other than common stock, issued with respect to common stock; (2) stock received tax free in a corporate reorganization or separation which has the effect of a stock dividend; and (3) stock deriving its basis from "306 stock."[9] By the enactment of section 306, the type of transaction that occurred in *Chamberlin* was stripped of its tax advantages. The entire amount realized from the sale of the stock is taxable as ordinary income.

Congress, however, realized that section 306 might produce hardships on individuals who were not using preferred stock as a tax avoidance device.[10] In an effort to prevent such hardships, Congress created exceptions in sections 306(b)[11] and 306(c)(2)[12] of the Code.

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[6] 18 T.C. 164 (1952).
[7] 207 F.2d 462 (6th Cir. 1953).
[8] 347 U.S. 918 (1954).
[9] Alexander & Landis, *Bailouts and the Internal Revenue Code of 1954*, 65 Yale L.J. 909, 917-39 (1956). *See* Treas. Reg. § 1.306-3 (1960); B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (¶ 10.03 (3d ed. 1971).
[10] Alexander & Landis, *supra* note 9, at 915-16.
[11] INT. REV. CODE of 1954, § 306(b), provides:

Exceptions. — Subsection (a) shall not apply —
(1) Termination of shareholder's interest. —
(A) Not in redemption. — If the disposition —
(i) is not a redemption;
(ii) is not, directly or indirectly, to a person the ownership of whose stock would (under section 318(a)) be attributable to the shareholder; and
(iii) terminates the entire stock interest of the shareholder in the corporation (and for purposes of this clause, section 318(a) shall apply).
(B) In redemption. — If the disposition is a redemption and section 302(b)(3) applies.
. . . .
(4) Transactions not in avoidance. — If it is established to the satisfaction of the Secretary or his delegate —

Section 306(b)(4), an important exception, removes the penalty for transactions that are not part of a plan primarily designed to avoid federal income tax.[13] Section 306(b)(4)(B) indicates that in the event of a prior or simultaneous disposition or redemption of the underlying common stock with respect to which the "section 306 stock" was issued, the disposition of "section 306 stock" will not be considered as part of a plan, a principal purpose of which was to avoid the federal income tax.[14] In the regulations, the Commissioner agrees that if the provisions of section 306(b)(4)(B) are satisfied, then proof that the disposition was not in pursuance of a plan to avoid federal income tax is unnecessary.[15]

In *Fireoved*, the taxpayer claimed that the sale of twenty-four percent of the common stock underlying his preferred stock should, pursuant to section 306(b)(4)(B), remove the "taint" from twenty-four percent of his preferred stock and allow the taxpayer to treat disposition of those shares as capital gain. The Commissioner contended that section 306(b)(4)(B) only applied to cases where the shareholder disposed of all his underlying common stock before disposing of his "section 306 stock."[16] The district court, agreeing with the taxpayer, reasoned that the exception granted in section 306(b)(4) could not be isolated from the other exceptions granted under section 306(b).[17] In particular, section 306(b)(1) grants an exception if the

(A) that the distribution, and the disposition or redemption, or
(B) in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, that the disposition (or redemption) of the section 306 stock,
was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax.

[12] INT. REV. CODE OF 1954, § 306(c)(2), provides:
Exception where no earnings and profits.—For purposes of this section, 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.

[13] For the text of INT. REV. CODE of 1954, § 306(b)(4), see note 11.

[14] For the text of INT. REV. CODE of 1954, § 306(b)(4)(B), see note 11.

[15] Treas. Reg. § 1.306-2(b)(3) (1968), in pertinent part provides:
However, in the case of a prior or simultaneous disposition (or redemption) of the stock with respect to which the section 306 stock disposed of (or redeemed) was issued, it is not necessary to establish that the distribution was not in pursuance of such a plan. . . . [I]f a shareholder received a distribution of 100 shares of section 306 stock on his holdings of 100 shares of voting common stock in a corporation and sells his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock would not ordinarily be considered a disposition one of the principal purposes of which is the avoidance of Federal income tax.

[16] 318 F. Supp. 144.

[17] *Id.* at 143-45.

transaction terminates the shareholder's entire stock interest in the corporation.[18] The district court concluded that to require a taxpayer to part with all of his common stock in order to qualify under section 306(b)(4)(B) would render the section meaningless because section 306(b)(1) covers this contingency.[19] Consequently, the district court allowed the taxpayer to treat twenty-four percent of the proceeds on the redemption of the preferred stock as capital gain.[20] The district court considered ownership of the underlying common stock to be the crucial test for the exception.

The district court's holding that section 306(b)(4)(B) would be rendered meaningless by the adoption of the Commissioner's position is not an easy one to understand. Section 306(b)(1) does not, in all cases, apply to a taxpayer who disposes of all his underlying common stock. In the instant case, for example, if the taxpayer had disposed of all his common stock before the company redeemed 451 shares of his preferred stock, he would have qualified for an exception to section 306 treatment by satisfying section 306(b)(4)(B). However, the taxpayer would not have qualified for an exception under section 306(b)(1) because he still owned 149 shares of preferred stock; he had not terminated his entire stock interest in the corporation as required by section 306(b)(1).

The circuit court looked beneath the ownership of the common stock to the realities of control in the corporation.[21] When the company was merged with Girard Business Forms, the corporate by-laws were amended to require unanimous consent of the directors for corporate action and a vote of seventy-six percent of the outstanding common stock or a unanimous vote of the directors to amend the by-laws.[22] As previously noted, the taxpayer retained 25⅓ percent of the outstanding common stock after his sale to Edelmayer; he retained an effective veto power over corporate activities. The circuit court concluded that to except the taxpayer from section 306 treatment would be unrealistic where the taxpayer had disposed of only a portion of the underlying common stock and had retained the same basic control over the corporation.[23] The circuit court considered control

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[18] For the text of INT. REV. CODE of 1954, § 306(b)(1), see note 11.
[19] 318 F. Supp. at 144.
[20] *Id.*
[21] 462 F.2d at 1288-90.
[22] *Id.* at 1289.
[23] *Id.*

of the corporation to be a major factor in qualifying for the exception.

Both the circuit and district courts relied upon the Senate Report on section 306(b)(4)(B) for support.[24] In the discussion of that section, the report used as an example a taxpayer who had disposed of his entire voting common stock before disposing of his "section 306 stock." The report concluded that the transaction was not treated as a tax avoidance disposition since the taxpayer had parted with the stock that allowed him to participate in the ownership of the business.[25] This appears to bolster the district court's holding that ownership, not control, is the basis for the exception. The report cautioned, however, that variations of its example may not be within the exception. To illustrate this, it hypothesized a case in which a corporation had only one class of common stock with respect to which it issued section "306 stock." Subsequently, to take advantage of section 306(b)(4)(B), the corporation issued a new class of common stock with greater voting rights than the first class and then disposed of all of its first class of common, as well as its "section 306 stock," retaining the second class of common stock. The Senate concluded that even though the stock underlying the "306 stock" was disposed of, the "306 stock" could not qualify for an exception from section 306 treatment.[26] This supports the circuit court's contention that control is the key since, in this example, the taxpayer tried to avoid taxes while maintaining control of the company. The circuit court's interpretation seems logical. If the purpose of a bailout is to withdraw profits at the capital gain rates while maintaining corporate control, and the purpose of section 306 is to negate the use of this device, then it is reasonable to assume that the Senate constructed its hypothetical case to emphasize the importance of corporate control. Ignoring corporate control might lead to abuses that section 306 was designed to prevent. Assume that a closely held corporation is organized to insure that each director will have a veto power over corporate activities. Assume further that: (1) These directors are elected by different classes of common stock and the taxpayer is the sole owner of one hundred shares of a class of stock that has the right to elect one director; and (2) taxpayer is in financial trouble. The other directors, in order to keep his services, agree to issue

[24] *Id.*; 318 F. Supp. at 144-45.
[25] S. REP. No. 1622, 83d Cong., 2d Sess. 244 (1954).
[26] *Id.*

preferred stock with respect to his class of common stock and to redeem every share of his preferred as well as ninety-nine shares of his common stock. Taxpayer would still retain a veto power over corporate activities by his ability to elect a director with his remaining one share of common stock. Under the district court's ruling, ninety-nine percent of the gain from the redeemed preferred stock would be taxed as capital gain.[27] The circuit court's analysis would require taxation of all the proceeds as ordinary income. It appears that the circuit court's opinion is more consistent with the purpose of section 306, which is the elimination of the "preferred stock bailout."

Only the Court of Appeals for the Third Circuit has decided this question. Speculation about future litigation in this area is tenuous. If a taxpayer disposes of his entire voting stock, he will not normally be taxed at ordinary rates on his "section 306 stock." If he disposes of only a portion and retains essentially the same control over the corporation, he will run afoul of the Third Circuit's ruling. The Third Circuit's holding that control is an important factor in granting exceptions to section 306 treatment under section 306(b)(4)(B) seems reasonable and should be followed. However, the Third Circuit's opinion does not decide the status of a taxpayer who, in giving up a portion of his voting stock, relinquishes effective control of the corporation.[28] There exists the possibility that the Third Circuit would allow a proportionate reduction under those circumstances. Still, a taxpayer should proceed with caution if he wishes to dispose of "306 stock" without first disposing of his entire voting stock upon which the "306 stock" is based; the Commissioner has embraced the position that a *complete divesture* of voting stock is necessary to qualify one for an exception to section 306 under section 306(b)(4)(B).

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[27] Note, however, that it still might be taxable under sections 301 and 302 as essentially equivalent to a dividend.

[28] 462 F.2d at 1290 n.14. The circuit court limited its decision to the facts and specifically disclaimed any view on the situation where a taxpayer disposes of only a portion of the underlying stock while relinquishing effective control of the corporation prior to the disposition of "section 306 stock."