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MICHAEL B. LANG *

Introduction

Funding for the sale of an interest in a profitable closely held corporation often comes from two sources: the buyer and the corporation itself. Such a bootstrap stock acquisition may take one of three forms. Two possible forms involve a distribution by a corporation to a selling shareholder: The corporation may either redeem a portion of the selling shareholder’s stock or distribute a dividend to the selling shareholder. The redemption or dividend distribution may be in cash, or in other property. A distribution to a selling shareholder may be taxed to a buyer (either a purchaser or a continuing shareholder) as a constructive dividend, on the theory that the buyer purchased all of the seller’s stock and then received a dividend distribution from the corporation. The distribution is then treated as part of the amount realized by the selling shareholder on the sale of stock to the buyer. The distribution may instead be taxed to the selling shareholder as a dividend or as a redemption of a portion of his stock.

In a third form of bootstrap stock acquisition, the buyer may purchase all of the seller’s stock and cause the corporation to make a subsequent distribution (to the buyer). The transaction may then be taxed in ac-

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cordance with its form, or an attempt may be made to have it taxed as if the distribution had actually been made to the seller. In any event, these potentially different tax consequences do not reflect any substantive economic differences that flow from the way in which the bootstrap stock acquisition is implemented; the pretax economic consequences to the parties are the same regardless of the transaction's form or tax treatment. Furthermore, the set of tax consequences resulting from any particular bootstrap stock acquisition plan is often unclear under current law.

This article examines the current tax treatment of bootstrap stock acquisitions. The first part of the article analyzes the stakes involved when economically equivalent bootstrap stock acquisitions are taxed in different ways. The discussion also highlights the extent to which the complexity created by current law is exacerbated by differences dependent upon whether the distributee shareholder (whether seller or purchaser) is a corporation or an individual. The second part of the article evaluates the principal (and at times conflicting) standards applied under current law to recharacterize bootstrap stock acquisitions for tax purposes, and concludes that these standards are generally inappropriate. The third part considers alternative approaches to taxing bootstrap stock acquisitions and concludes that the best approach would be to treat all distributions made in connection with bootstrap stock acquisitions as if they were made in redemption of an appropriate portion of the seller's stock in the corporation. The fourth and final part of the article concludes with observations and recommendations about the implementation of such an approach.

Comparison of Stakes Under Alternative Bootstrap Stock Acquisition Plans

The different tax consequences that may attend a bootstrap stock acquisition are best illustrated by example. For a simple case, assume a seller (S) owns all of the common stock of a domestic corporation (C) which is worth $100,000, of which $30,000 represents cash. Assume further that the corporation's accumulated earnings and profits\(^1\) total $50,000 on the date of the bootstrap stock acquisition, and that S's adjusted basis in the stock of C is $20,000. Finally, assume that the prospective purchaser (P) does not want the cash in C, but instead expects to

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\(^1\) The example refers to accumulated earnings and profits because a redemption treated as a redemption only results in a charge against accumulated (and not current) earnings and profits. I.R.C. § 312(n)(8). This redemption-dividend distinction is discussed in the text accompanying notes 9 and 17–19.
pay $70,000 for C without cash. S, of course, is indifferent in a nontax world as to the source of the $100,000 he will receive for his C stock. Tax considerations aside, P's bootstrap acquisition of C may take one of three forms:

(1) P may purchase 70% of S's stock for $70,000, with C redeeming the remainder of S's stock for $30,000 as part of the plan. (This alternative is hereinafter referred to as either plan I or the S-Redemption Plan.) It makes no difference under current tax law whether the redemption takes place before, simultaneously with, or subsequent to the sale of stock to P.2

(2) C may distribute a dividend to S in the amount of $30,000, followed by P's purchase of all of S's stock for $70,000. (This alternative is hereinafter referred to as plan 2 or the S-Dividend Plan.)

(3) P may purchase all of S's stock for $100,000, followed by C's distribution of a dividend to P in the amount of $30,000.3 (This alternative is hereinafter referred to as plan 3 or the P-Dividend Plan.)

Absent the peculiar aberrations developed by the case law and discussed in the second part of this article, each of the above plans results in a different set of tax consequences for P, S, and C. Under plan I, S is treated as selling 70% of his stock to P for $70,000, and the remaining 30% to C for $30,000.4 These sales qualify for long-term capital gain treatment if S has held the stock for the required holding period, at this

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3 A redemption of a portion of P's stock in C following P's purchase of all of C's stock would be treated as a dividend under §§ 302(d), 301, and 316. Cases can be hypothesized in which several purchasers acquire C and only one of the purchasers has stock redeemed as part of the bootstrap stock acquisition plan, so that the redemption would not be treated as a dividend. These transactions, however, are likely to be sufficiently rare in practice to be ignored in this discussion.

4 See I.R.C. § 302(a). In particular, the redemption will qualify as a complete termination of S's interest in C viewed in conjunction with the sale of stock to P. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954); Monson v. Commissioner, 79 T.C. 827 (1982).

This conclusion assumes that P's ownership of C stock after the transactions is not attributable to S by the constructive stock ownership rules of § 318. However, if S receives redemption payments in a form (for example, convertible debentures) indicating a continuing interest in C, S may be treated as receiving a dividend. Furthermore, if S's stock is redeemed as part of a plan to terminate his interest over an extended period of time, any particular redemption, albeit part of a larger plan, may constitute a distribution essentially equivalent to a dividend. See, e.g., Friend v. United States, 345 F.2d 761 (1st Cir. 1965) (indefinite period).
time, more than six months. Under current law, long-term capital gain treatment of a redemption offers two advantages over dividend treatment: (1) The redeemed shareholder offsets the redemption proceeds by his adjusted basis in the shares redeemed in order to compute his gain from the redemption, and (2) the gain is subject to tax at the lower effective tax rate applicable to long-term capital gains. S will then have $80,000 of long-term capital gain ($100,000 amount realized from C and P less $20,000 adjusted basis). If S is an individual, S’s tax on the gain will be no more than $16,000 (20% of the $80,000 gain). A corporate S, however, may pay a tax on such a gain of up to $22,400 (28% of the $80,000 gain).

Under plan I, P will have a cost basis of $70,000 in the stock of C. If P shortly thereafter sells the C stock for its then fair market value of

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6 See I.R.C. § 1222(3). Section 302(a) treats a redemption as a “sale or exchange” of the redeemed stock, with the result that a redemption of stock (usually a capital asset under § 1221), normally produces capital gain or loss within the meaning of paragraphs (1) to (4) of § 1222.

6 This advantage would also follow if a short-term capital gain resulted. This advantage of capital gain treatment for a redemption is of limited importance in a bootstrap stock acquisition context because any basis not used to offset redemption proceeds will be taken into account in computing gain or loss on the sale of the remaining stock to P, as under plan 2. If the shareholder’s adjusted basis in the redeemed stock exceeds the redemption proceeds, a capital loss results. See J.C. Fleming, Tax Aspects of Buying and Selling Corporate Businesses § 5.06 (1984). This possibility does not seem to occur often for sellers in actual bootstrap stock acquisitions; at least, it is not reflected in the cases. Accordingly, any potential trade-off of ordinary income (dividends) for capital losses (sale for less than adjusted basis) is ignored hereinafter, and, for the sake of simplicity, the term “capital gain” in the text should be read to refer to the possibility of capital loss as well.

7 The 20% rate results from multiplying the highest rate applicable to individuals (50%) by the 40% inclusion ratio for net long-term capital gains which results from the 60% net capital gain deduction under § 1202. While the net capital gain deduction constitutes a tax preference item under § 57(a)(9)(A), the alternative minimum tax, imposed at a rate of 20% on a tax base which effectively eliminates the net capital gain deduction, merely reinforces the 20% maximum rate on long-term capital gains. It should be noted that those who realize long-term capital gains may, in fact, bear a much heavier tax burden than this discussion suggests once state taxes are also taken into account; some states tax capital gains at the rates applicable to ordinary income. See, e.g., Mass. Gen. Laws Ann. ch. 62, § 2(d)(1) (West Supp. 1985); Ill. Ann. Stat. ch. 120, § 2-203(a)(2)(B) (Smith-Hurd, West Supp. 1985).

8 The 28% rate derives from the alternative tax for corporations provided by § 1201(a). If a corporate S owns 100% of C and C and S have not previously filed consolidated returns, they may do so in the year of sale. I.R.C. § 1501; Reg. § 1.1502-75. S may elect, through a deemed dividend procedure, to increase its basis in the stock of C by the amount of C’s undistributed earnings and profits from pre-consolidation years. Reg. § 1.1502-32(f)(2). This procedure would eliminate C’s earnings and profits. See infra note 225. In such a situation, redemption treatment of a distribution to a corporate S in the context of a dividend alternative is extremely unlikely to occur.
$70,000, P will not recognize any gain or loss, because his $70,000 amount realized will equal his adjusted basis in the stock. Strangely enough, plan J and the doctrines applied by the courts at the Commissioner's behest do not lead to this obviously sensible result.

Plan I will not affect C's income. The redemption of 30% of $S's stock by C, however, will result in a reduction of C's accumulated earnings and profits by $15,000 (the ratable share of C's $50,000 of accumulated earnings and profits attributable to the stock redeemed). See I.R.C. § 312(e), repealed by DRA 1984, § 61(a)(2)(B). Thus, a redemption distribution could offset more than the proportionate share of the earnings and profits of the distributing corporation attributable to the redeemed stock, with the result that a smaller amount of earnings and profits remained to color subsequent distributions as dividends. See S. Rep. No. 169, 98th Cong., 2d Sess. 197–98 (1984) [hereinafter cited as S. Rep. No. 169]; Staff of Joint Comm. on Tax'n, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 177, 181 (1985) [hereinafter cited as 1984 General Explanation].

The correct interpretation of § 312(e) was also a matter of some dispute. See generally Edelstein & Korbel, The Impact of Redemption and Liquidation Distributions on Earnings and Profits: Tax Accounting Aberrations Under Section 312(e), 20 Tax. L. Rev. 479 (1965); Katcher & Hindin, The Role of Earnings and Profits in Planning Stock Redemptions, 30 U. So. Cal. Tax Inst. 1 (1978); LeMaster, The Effect of a Stock Repurchase Upon Earnings and Profits of a Public Corporation, 2 J. Corp. Tax'n 476 (1976); Regante, Adjusting Earnings and Profits Under Internal Revenue Code Section 312(e), 52 St. John's L. Rev. 116 (1977); Reid, To What Extent Will Distributions in Redemption of Stock Reduce Earnings and Profits?, 42 J. Tax'n 29 (1975); Staker, Revenue Ruling 79–376—Effect of Section 312(e) Redemptions Distributions on Earnings and Profits, 34 Tax Law. 817 (1981).

Thus, up to $35,000 of any subsequent distribution by C will be out of accumulated earnings and profits (assuming no subsequent adjustment) and, hence, potentially a dividend under §§ 301 and 316. However, if a corporate P makes or is deemed to make a § 338 election with respect to the purchase of stock in C, C's preacquisition earnings and profits will be eliminated. See I.R.C. § 338(a).

I.R.C. §§ 301, 316. There are sufficient accumulated earnings and profits, $50,000, to make the entire $30,000 a dividend under § 316.
term, will not exceed $10,000 for an individual S (20% of the $50,000 gain)\textsuperscript{12} or $14,000 for a corporate S (28% of the $50,000 gain).\textsuperscript{18}

The $30,000 dividend will generally be included in full in S's gross income,\textsuperscript{14} potentially subject to tax in the case of an individual S at a rate of 50%\textsuperscript{.}\textsuperscript{19} Hence, an individual S's tax on the dividend may be as high as $15,000, so that his total tax under plan 2 may be as high as $25,000. A corporate S, however, may be entitled to deduct the full amount of the dividend received from C under section 243(a)(3),\textsuperscript{16} and, in any event, will probably be entitled to deduct at least 85% of the dividend received under section 243(a)(1).\textsuperscript{19} Assuming the 100% dividends received deduction is available, a corporate S will pay no more than $14,000 in tax under plan 2.

The tax consequences to P under plan 2 parallel the tax consequences to P under plan 1: P will have a cost basis of $70,000 in the stock of C.

Plan 2 will not affect C's income. However, C's earnings and profits will be reduced by the full amount of the dividend distribution (unlike

\textsuperscript{12} See supra note 7.

\textsuperscript{18} See supra note 8.

\textsuperscript{14} Section 116 excludes from an individual's gross income $100 ($200 in the case of a joint return) of certain dividends received from domestic corporations. This provision's impact, however, is sufficiently de minimis in the context of bootstrap acquisitions that it will be hereinafter ignored.

\textsuperscript{15} In general, a corporate S (owning 100% of C) is entitled to the 100% dividends received deduction if the requirements of § 243(b)(1)(B) (relating to source year of earnings and profits distributed) are met, a § 243(b)(2) election is in effect for the affiliated group of which S and C are members for the taxable year, and the holding period requirement of § 246(c) is satisfied with respect to S's stock in C. The making of a § 243(b)(2) election has various collateral consequences, such as limiting the affiliated group to one accumulated earnings credit under § 535(e). The collateral consequences are set forth in § 243(b)(3). For the definition of an affiliated group, see § 1504(a) (chain of corporations in which parent at each level of chain owns 80% of voting power and value of stock of subsidiary at next lower level). See generally 1984 General Explanation, supra note 9, at 170–73. Section 246(c) disallows any dividends received deduction if the underlying stock has been held 45 days or less. For the reason for the 1984 lengthening of this requirement from the earlier 16-day standard, see 1984 General Explanation, supra note 9, at 137, 141–42.

If C and S file consolidated returns for the taxable year in which the dividend is distributed, the dividend is eliminated from C's taxable income under the consolidated return regulations. See Reg. §§ 1.1502–12(a), 1.1502–14(a).

\textsuperscript{16} The 85% dividends received deduction generally applies in bootstrap stock acquisitions under plan 2 involving multiple S's as to a corporate S owning less than 80% of C prior to the sale. The stakes in such a situation are obviously somewhat different from the stakes in a 100% deduction case, but the 100% deduction case is used as an example throughout this article in an effort to reduce a complex problem with numerous variables to the bare essentials. See also section 301(f), which requires a corporate S with a 20% or greater interest in C to determine its taxable income and basis in C's stock as if § 312(n) (providing adjustments to earnings and profits to more accurately reflect economic gain and loss), did not apply to C. See H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1205–07 (1984); 1984 General Explanation, supra note 9, at 182–83.
the plan I adjustment for a redemption distribution), giving C accumulated earnings and profits of $20,000 after implementation of plan 2.\textsuperscript{17} The earnings and profits adjustment resulting from a dividend distribution would apply first to the current taxable year's earnings and profits, if any existed, with the amount of the dividend not so applied then reducing previously accumulated earnings and profits.\textsuperscript{18} This aspect of the earnings and profits adjustment for a dividend distribution also differs from the adjustment on account of a redemption distribution, the latter only resulting in a charge against the accumulated earnings and profits as of the date of the distribution.\textsuperscript{19}

Under plan 3, S will sell all of his C stock to P for $100,000. The tax consequences to S will parallel those under plan I. Assuming S has satisfied the holding period requirement, S will have $80,000 of long-term capital gain ($100,000 realized on sale to P less $20,000 adjusted basis). An individual S will owe tax on this capital gain of no more than $16,000,\textsuperscript{20} while a corporate S's tax on this capital gain may be as high as $22,400.\textsuperscript{21}

Under plan 3, P will receive a dividend of $30,000. This amount will generally be includable in full in an individual P's gross income,\textsuperscript{22} and may be subject to tax at a rate of up to 50%. Hence, an individual P may be liable for a tax of as much as $15,000 under plan 3.

A corporate P, although owning all of C, will not qualify for the section 243(a)(3) 100% dividends received deduction with respect to a plan 3 dividend distribution except to the extent the distribution is made out of C's earnings and profits of a taxable year beginning after the acquisition of C by P.\textsuperscript{23} A dividend distribution to P in connection with a

\textsuperscript{17} I.R.C. § 312(a)(1). Hence, only $20,000 of a subsequent distribution will potentially constitute a dividend under §§ 301 and 316. For the effect of a § 338 election by P on C's earnings and profits, see note 10.

\textsuperscript{18} This is not spelled out in § 312, but necessarily follows from the § 316 definition of a dividend. See Reg. § 1.316–2(a).

\textsuperscript{19} I.R.C. § 312(a)(8). The redemption adjustment probably applies to only accumulated earnings and profits because the redeemed stock cannot properly be viewed as sharing in earnings and profits of the corporation's current taxable year earned after the redeemed shareholder's interest in the corporation has terminated. Cf. I.R.C. § 356(a)(2) (boot distribution in reorganization having effect of a dividend distribution treated as dividend to extent of distributee's pro rata share of accumulated earnings and profits); Rev. Rul. 74–164, 1974–1 C.B. 74 (calculation of accumulated earnings and profits if current deficit).

\textsuperscript{20} See supra note 7.

\textsuperscript{21} See supra note 8.

\textsuperscript{22} But see supra note 14 (limited exclusion under § 116).

\textsuperscript{23} See I.R.C. § 243(b)(1)(B). For this purpose, a dividend is considered to be distributed first out of the earnings and profits of the taxable year in which the distribution takes place. Reg. § 1.243–4(a)(6). Hence, a dividend distribution made in the first taxable year of C beginning after the acquisition of C by P will qualify for the 100% dividends received deduction to the extent C has current
bootstrap stock acquisition is unlikely to satisfy this test for the most part because (1) $P$ may not want to wait until $C$'s next taxable year to receive the dividend, (2) $C$ may not have current earnings and profits in the taxable year involved, or (3) the dividend distribution sought may far exceed $C$'s earnings and profits for the post-acquisition taxable years. In general, then, a corporate $P$ (not filing a consolidated return with $C$) will only be entitled to an 85% dividends received deduction for the dividend received from $C$ under plan 3.\(^{24}\) Hence, a corporate $P$ may pay a tax of up to $2,070 (15% inclusion of $30,000 dividend or $4,500 times 46% rate)\(^{25}\) under plan 3.

A corporate $P$ which files a consolidated return with $C$ for the taxable year in which the plan 3 dividend distribution is made will be able to eliminate the dividend from gross income.\(^{26}\) The source year of the earnings and profits distributed as a dividend will not affect $P$'s ability to eliminate such a dividend from gross income on a consolidated return, but it will affect $P$'s basis in the stock of $C$.

In most cases, $P$ will receive a $100,000 cost basis in the stock of $C$ acquired under plan 3. There are two exceptions: First, a corporate $P$ who sells or otherwise disposes of the $C$ stock within one year of its acquisition will have to reduce its basis in the $C$ stock by the nontaxed portion of any extraordinary dividend received with respect to the stock.\(^{27}\) This provision addresses dividends for which deductions are

\(^{24}\) I.R.C. § 243(a)(1). Section 246A reduces the 85% dividends received deduction in the case of dividends received on "debt-financed portfolio stock." This provision was added in 1984 to correct a perceived abuse resulting from corporate entitlement to the dividends received deduction with respect to dividends received on stock financed with proceeds of a loan as to which a § 163 interest deduction was also available. See H.R. REP. NO. 432, 98th Cong., 2d Sess. 1180 (1984); S. REP. NO. 169, supra note 9, at 165; H.R. REP. NO. 861 (Conf. Rep.), 98th Cong., 2d Sess., 811–14 (1984), reprinted in 1984–3 C.B. 1; 1984 GENERAL EXPLANATION, supra note 9, at 128–33. However, the definition of "portfolio stock" probably renders § 246A inapplicable to most purchasers in bootstrap stock acquisitions, including a corporate $P$ in plan 3 discussed in the text. In particular, § 246A(c)(2) defines portfolio stock as any corporate stock unless, as of the beginning of the ex-dividend date for the dividend involved, either (1) the taxpayer ($P$) owns stock possessing at least 50% of the total voting power and having a value equal to at least 50% of the total value of the corporation's ($C$'s) stock (ignoring certain preferred stock), or (2) the taxpayer owns stock possessing at least 20% of the total voting power and representing at least 20% of the total value of the corporation's stock (again ignoring certain preferred stock) and five or fewer corporations own enough of the corporation's stock to satisfy the 50% tests in the aggregate. Few purchasers in bootstrap stock acquisitions are likely to acquire "portfolio stock," with or without debt financing, under this definition.

\(^{25}\) See I.R.C. § 11.

\(^{26}\) See Reg. §§ 1.1502–12(a), 1.1502–14(a).

\(^{27}\) I.R.C. § 1059(a). This provision only applies to distributions made after
allowable under sections 243, 244, and 245, and does not appear to apply to dividends eliminated from gross income under the consolidated return regulations. Since any dividend in an amount equal to or greater than 10% of the shareholder's adjusted basis in the stock constitutes an extraordinary dividend, a corporate P who sells or disposes of its C stock within one year of acquiring the C stock under plan 3 will have to reduce its basis in the C stock by $25,500 (85% of the $30,000 dividend received from C). Thus, such a P will have an adjusted basis of $74,500 in the stock of C. Nonetheless, a quick sale of the C stock by P seems an unlikely scenario in the context of a bootstrap acquisition, and this possibility will be henceforth ignored.

The second exception to the full $100,000 basis for P in the stock of C will arise if a corporate P eliminates the plan 3 dividend distribution from gross income under the consolidated return regulations. In such a situation, P's basis in the stock of C will be reduced by the full amount of the dividend distribution, and will therefore be only $70,000.

Plan 3 tax consequences for C parallel those resulting from plan 2. C's income is not affected, but C's earnings and profits are reduced by the full amount of the dividend distribution, giving C accumulated earnings and profits of $20,000 after implementation of plan 3.

Selected aspects of the preceding discussion are set forth in the Appen-

March 1, 1984. DRA 1984, supra note 9, 98 Stat. at 568. It was enacted as part of an effort to thwart several abusive practices, the most notable of which was a transaction pursuant to which a taxpayer would purchase stock dividend-on, receive the dividend, and then sell the stock ex-dividend at a price that was lower by the amount of the dividend, thus producing a short-term capital loss. This combination would, of course, be an economic wash. But, a corporate taxpayer with an unrelated short-term capital gain could thereby eliminate a 46% tax on the short-term capital gain with the resulting capital loss at the cost of a tax on the dividend reduced by the 85% dividends received deduction, this latter tax amounting to a mere 6.9% (46% multiplied by the 15% effective inclusion of dividends received by corporations). See H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. 1184–88 (1984); S. Rep. No. 169, supra note 9, at 170–75; H.R. Rep. No. 861 (Conf. Rep.), 98th Cong., 2d Sess. 816–19 (1984), reprinted in 1984–3 C.B. 1; see generally 1984 GENERAL EXPLANATION, supra note 9, at 136–41.

28 I.R.C. § 1059(c). Section 1059(c) requires aggregation of all dividends having ex-dividend dates within a period of 85 days, and also requires aggregation of all dividends having ex-dividend dates within a period of 365 days if the aggregate amount of such dividends exceeds 20% of the shareholder's adjusted basis in the stock.

29 "Nontaxed portion" is defined in the expected way by § 1059(b).

30 See Reg. § 1.1502–32(b)(2)(iii)(c) (referring to earnings and profits accumulated in "separate return limitation years" of the subsidiary, C). For the definition of the term "separate return limitation year," see § 1.1502–1(f) of the regulations.

31 See supra note 17. The same earnings and profits result follows if a corporate P and C file a consolidated return for the taxable year in which the dividend is distributed. See Reg. § 1.1502–33(c)(1).
dix. Comparison of the three alternative bootstrap stock acquisition plans reveals several important points. First, plan I will generally be preferable to plan 2 for an individual S, while plan 2 is likely to be preferable to plan I for a corporate S.

Second, plan 3 offers no significant advantage to either P or S, in most cases. From S's standpoint, plan 3's results are generally achievable under plan I—that is, by using a redemption of S's stock to remove $30,000 from C. In addition, a corporate S will generally prefer plan 2 to plan 3. From a corporate P's standpoint, plan 3 offers the possibility of an increase in the basis of the C stock (from $70,000 to $100,000), except in cases to which section 1059 applies, at the cost of a relatively light tax, 6.9% of the increase in basis. Whether this is advantageous or disadvantageous to P cannot be determined in the abstract, even on a general basis, particularly if P intends to hold the C stock for many years. In the case of a corporate P filing a consolidated return with C for the taxable year of a plan 3 distribution, plan 3 offers no advantage over plan 2 and only a reduced earnings and profits account for C as compared with plan I. This latter difference, present in all corporate P plan 3 cases, is probably not very important inasmuch as the reduced level of C's earnings and profits will be counterbalanced by an increase in P's earnings and profits as a result of the dividend distribution from C to P. The amount of C's earnings and profits is only likely to be of concern to a subsequent individual purchaser of C.

From an individual P's standpoint, however, plan 3 simply imposes an immediate tax at ordinary income tax rates (as high as 50%) on a dividend in return for a higher ($100,000, instead of $70,000) basis in the C stock. But the C stock is only worth $70,000 after plan 3 is implemented; hence, the higher basis seems inappropriate. The fact that C's earnings and profits following implementation of plan 3 will be lower (and therefore offer less dividend potential) than they would be following implementation of plan I hardly seems enough of a benefit to offset the penalty of immediate taxation.

While an individual P might find plan 3 attractive under unusual circumstances—such as when he has a net operating loss carryover which

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\[82 \text{See supra text accompanying notes 27–29.}\]

\[83 \text{See Reg. § 1.1502–33(c)(1). For the effect of a § 338 election by P on C's earnings and profits, see note 10. Since the earnings and profits impact of a § 338 election with respect to C does not depend on the form of the transaction, it is not likely to affect the structuring of a particular transaction. The impact of a § 338 election with respect to the acquisition of C stock on P's earnings and profits will, however, depend on the form of the transaction.}\]

\[84 \text{The higher basis seems at least as inappropriate in the case of a corporate P which does not file a consolidated return with C, perhaps even more so because of the 85% dividends received deduction. Section 1059 addresses this problem, but only in a very narrow context.}\]
is about to expire—these unusual circumstances do not appear in the cases. Instead, taxpayers attempting to avoid using plan 3 have suffered an unending onslaught of government arguments that bootstrap stock acquisitions made under various versions of plans 1 and 2 should be taxed as if made under plan 3.\textsuperscript{35} While there has been other litigation about the proper tax treatment of bootstrap stock acquisitions, the majority of the cases involve government attempts to recharacterize plan 1 or plan 2 transactions as plan 3 transactions.\textsuperscript{36} The second part of this article examines the legal standards that have evolved through the development of the case law and administrative pronouncements; it generally concludes that to the extent those standards lead to taxing a plan 1 or plan 2 transaction as if it were a plan 3 transaction, they should be rejected. The third part then considers more generally how a bootstrap stock acquisition should be taxed, concluding that plan 1 is the proper model for the tax treatment of all bootstrap stock acquisitions, whatever their form.

At this juncture, however, it is important to note the effect of a distribution in kind of appreciated property as part of a bootstrap stock acquisition. Such a distribution will trigger application of tax law provisions in addition to those set forth above. However, the possibility of such a distribution as part of a bootstrap stock acquisition plan will not affect the analysis and conclusions of this article. This is largely because Congress has recently moved toward rationalizing the treatment of these distributions by (1) generally making them occasions for recognition of gain to the distributing corporation, (2) limiting the exceptions to gain recognition, and (3) treating redemptions and dividends similarly in most contexts.

Under section 311(d), as amended in 1984, a corporate distribution in kind of appreciated property will generally result in recognition of

\textsuperscript{35} See, e.g., Reitz v. Commissioner, 61 T.C. 443 (1974), aff'd per unpublished opinion (5th Cir., Jan. 23, 1975) (taxpayer donor's attempt to characterize pre-gift dividend as redemption rejected); Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (unsuccessful attempt to structure purchase of stock so that corporate seller could treat purchase price as an intercompany dividend eliminated from income under the then effective consolidated return regulations). These cases are discussed in the text accompanying notes 154–56.

\textsuperscript{36} Purchasers have occasionally attempted to have transactions implemented in the plan 3 form recharacterized as plan 1 transactions for tax purposes. These attempts have usually failed. See, e.g., Television Indus., Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955). But see Decker v. Commissioner, 32 T.C. 326 (1959), noneq., aff'd per curiam, 286 F.2d 427 (6th Cir. 1960) (pursuant to a plan, surviving shareholders bought stock from deceased shareholder's estate and immediately sold it to corporation for same price; held, no dividend to purchasing surviving shareholders because corporate cash really ended up in deceased shareholder's estate).
gain to the distributing corporation in an amount equal to the difference between the property's fair market value and its adjusted basis in the hands of the distributing corporation. When this provision applies to a distribution made by C to P or S in connection with a bootstrap stock acquisition, C will be taxed as if C first sold the distributed property for an amount of money equal to the property's fair market value and then distributed the money received. Furthermore, C will increase its earnings and profits by the amount of gain recognized upon the distribution of appreciated property, and then, reduce its earnings and profits as necessitated by the distribution. These tax consequences, however, do not directly affect the choice among the three alternative plans for carrying out a bootstrap stock acquisition.

In a few instances, the form of a distribution of appreciated property made in connection with a bootstrap stock acquisition plan does affect the distribution's tax impact. These situations are the residue of prior law, which provided that a corporation generally did not recognize gain on the distribution of appreciated property, with certain exceptions, unless the distribution was made in redemption of the corporation's stock. Corporations still need not recognize gain on distributions of appreciated

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37 See H.R. Rep. No. 432, Part 2, supra note 16, at 1189–91; H.R. Rep. No. 861 (Conf. Rep.), supra note 24, at 819–23; 1984 General Explanation, supra note 9, at 148–53. Loss is not recognized upon the distribution of property with a fair market value that is less than the property's adjusted basis in the hands of the distributing corporation. I.R.C. § 311(a). Gain may also be recognized to a corporation upon the distribution of LIFO inventory or property subject to a liability in excess of the property's adjusted basis to the corporation (or property distributed in conjunction with a shareholder assumption of a liability). I.R.C. § 311(b), (c). The latter provisions do not distinguish between distributions treated as redemptions and those treated as dividends. See also § 311(d)(1) (last sentence) (subsections (d), (e)) applies after subsections (b) and (c).

38 I.R.C. § 312(c)(3).

39 If C files a consolidated return for an appropriate taxable year with either a corporate P or a corporate S, C's gain on such a distribution of appreciated property may affect the consolidated income and tax liability of the affiliated group. It appears, however, that such gain will be treated as deferred gain under the consolidated return regulations. See H.R. Rep. No. 861 (Conf. Rep.), supra note 24, at 821; 1984 General Explanation, supra note 9, at 152; cf. Reg. § 1.1502–14(c)(1).

40 See H.R. Rep. No. 432, Part 2, supra note 16, at 1189; S. Rep. 169, supra note 9, at 176. For a recent study of this problem, see Task Force Report, Income Taxation of Corporations Making Distributions with Respect to Their Stock, 37 Tax Law. 625 (1984), which includes a Minority Report, 37 Tax Law. 638, followed by another view, Hawkins, A Discussion of the Repeal of General Utilities, 37 Tax Law. 641. Prior law curiously did not distinguish between redemptions treated as distributions to which § 301 applies (those taxed as dividends to the extent made out of earnings and profits) and redemptions to which § 302(a) applies (those taxed as distributions made in exchange for the redeemed stock). See Reg. § 1.311–2(a)(1) (as in effect with respect to distributions made prior
property in several situations. Three of these situations involve redemptions: (1) distributions to the extent section 303(a) (relating to distributions in redemption of stock to pay death taxes) applies,41 (2) certain distributions in redemption of stock held by a private foundation,42 and (3) certain redemption distributions made by regulated investment companies.43 In these cases, a redemption44 distribution in connection with a bootstrap stock acquisition will avoid the gain recognition to the distributing corporation that would attend an equivalent dividend distribution. Assuming a redemption distribution is made, the distributing corporation will still have to increase its earnings and profits by the amount by which the distributed property's fair market value exceeds its adjusted basis to the corporation.46

In other situations, a corporation may distribute appreciated property with respect to "qualified stock"46 without recognizing gain on the distribution, although the unrecognized gain will still increase the distributing corporation's earnings and profits.47 Gain is not recognized if a distribution of this sort (1) is made to a noncorporate shareholder either in partial liquidation of the distributing corporation,48 or in the form of a "qualified dividend" of property (other than property described in section 1221(1) or (4)) used by the distributing corporation in the active conduct of a "qualified business,49 or (2) is of stock or obligations of a controlled corporation substantially all of the assets of which consist of

to the effective date of DRA 1984). An actual redemption, as defined in § 317(b), was required, however. See Reg. § 1.311–2(a)(2) (as in effect with respect to distributions made prior to the effective date of DRA 1984).

44 Only an actual redemption is required; a redemption taxed as a dividend by virtue of § 302(d) is still a redemption in this context. See Reg. § 1.311–2(a), which has not been amended to reflect the enactment of DRA 1984.
45 See I.R.C. § 312(n)(4). The distributing corporation then reduces its earnings and profits in accordance with § 312(n)(8) if the distribution is treated as a redemption for tax purposes. For the impact of a distribution treated as a dividend for tax purposes, see note 47 and accompanying text.
46 "Qualified stock" is defined by § 311(e)(1).
47 I.R.C. § 312(n)(4). The statute suggests that the distributing corporation only reduces its earnings and profits in such a case by the adjusted basis of the property distributed. See I.R.C. § 312(a)(3). However, Congress purportedly intended for the distributing corporation in these circumstances to reduce its earnings and profits by an amount equal to its adjusted basis in the distributed property increased by any gain realized (even if not recognized) on the distribution. See 1984 General Explanation, supra note 9, at 179. H.R. 3838, 99th Cong., 1st Sess. § 1504(f) (1985), would amend § 312 to produce this result.
assets of one or more qualified businesses.\textsuperscript{60} The noncorporate shareholder partial liquidation provision and the controlled corporation distribution provision do not distinguish between dividend distributions and redemption distributions\textsuperscript{61}; thus, they should play no role in decisions as to the form chosen for a bootstrap stock acquisition. While the qualified dividend provision is expressly limited to dividends, its application to distributions of certain assets actually used by the distributing corporation in the active conduct of a qualified trade or business\textsuperscript{62} suggests it will play little role in bootstrap stock acquisitions inasmuch as distributions of nonbusiness assets, particularly liquid assets such as securities or cash, are more likely in connection with a bootstrap stock acquisition.\textsuperscript{58}

In any event, this qualified dividend situation and the redemption situations mentioned above\textsuperscript{64} are the only instances in which the form of a distribution of appreciated property made in connection with a bootstrap stock acquisition affects whether the distributing corporation must recognize income upon making the distribution. While not central to the

\textsuperscript{60}I.R.C. § 311(d)(2)(B) (referring to the requirements of § 311(e)(2)).

\textsuperscript{61}While this failure to distinguish between dividend and redemption distributions is evident from the statute in the case of distributions of stock or obligations of controlled corporations, the partial liquidation provision might be read as only applying to cases in which stock is actually redeemed. The legislative history dispels this impression. See H.R. Rep. No. 760 (Conf. Rep.), 97th Cong., 2d Sess. 530 (1982). Cf. § 302(e)(4) (pro rata redemption may qualify as partial liquidation).

\textsuperscript{62}The legislative history does not explain why the qualified dividend provision was enacted. See, e.g., H.R. Rep. No. 432, Part 2, supra note 16, at 1189–90. The appearance of the qualified dividend provision in tandem with the § 311(d)(2)(A) exception for partial liquidation distributions to noncorporate shareholders suggests, however, that it represents an extension of the partial liquidation provision to dividend distributions of business assets which are somewhat less substantial (in the context of the corporation's overall business activity) than a partial liquidation. If this is the rationale underlying the qualified dividend provision, there is no reason not to extend it to analogous redemptions as well. On the other hand, the qualified dividend exception may represent a rough compromise: dividend taxation to a shareholder individual, but no tax on the appreciation in the distributed property to the corporation. See 1984 GENERAL EXPLANATION, supra note 9, at 149–51 (suggesting that the dividend-redemption distinction was intentional). The GENERAL EXPLANATION contains an example of a distribution that qualifies only in part because it is only partly a dividend, but does not indicate how the nonrecognition of gain rule then applies. Presumably, realized gain is apportioned on the basis of the relative fair market values of the qualified dividend and nondividend portions of the distribution.

\textsuperscript{58} A purchaser in a bootstrap stock acquisition might want to have the acquired corporation make a distribution of real estate used in the active conduct of the corporation's business. However, such a distribution to the purchaser would generally be a dividend under §§ 302(d), 301, and 316, assuming sufficient earnings and profits, even if made in the form of a redemption. As a result, even in this case, the dividend-redemption distinction discussed in the text is unlikely to prove important.

\textsuperscript{64} See supra text accompanying notes 41–43.
bootstrap problem, these situations can easily be accommodated in the process of properly taxing bootstrap stock acquisitions.\textsuperscript{55}

A distribution of appreciated property in connection with a bootstrap stock acquisition may also result in tax consequences under section 338. First, a complete redemption of a minority shareholder's stock in C in connection with a qualified stock purchase\textsuperscript{56} of C's stock, as to which a section 338 election has been made, is not subject to the section 311(d) gain recognition provision regardless of whether the redeemed shareholder is a seller or a shareholder not otherwise participating in the transaction.\textsuperscript{57} As to S, this possibility adds an additional distinction in tax consequences between plan 1 and plan 2 in the limited context in which it may apply. The distinction seems to rest, in theory, on the fact that while a distribution of appreciated property in a redemption generally causes the distributing corporation to recognize gain, a liquidating distribution of appreciated property generally does not cause gain recognition. If a section 338 election has been made, a liquidation is deemed to have occurred; hence, nonrecognition of gain to the corporation is viewed as appropriate for related distributions of appreciated property to minority shareholders.\textsuperscript{58} As such, this distinction seems acceptable and can be accommodated in any revised approach to taxing bootstrap stock acquisitions.

Second, section 338(e)(1) will deem a corporate P to have made a section 338 election as to a qualified stock purchase of C's stock if, during a defined consistency period,\textsuperscript{60} it receives a distribution of any appreciated asset from C which does not qualify for nonrecognition of gain under section 311(d)(2). Hence, most distributions of appreciated property by C to a corporate P in these limited circumstances will trigger a deemed section 338 election.\textsuperscript{60} While section 311(d)(2) distinguishes between redemptions and dividends in limited instances, as noted

\textsuperscript{55} See infra text accompanying notes 229–54.

\textsuperscript{56} "Qualified stock purchase" refers to any transaction or series of transactions in which a corporation (P) during a 12-month period acquires by purchase at least 80% of the total combined voting power of all classes of stock entitled to vote and 80% of the total number of shares of all other classes of stock (except certain nonvoting preferred stock) of another corporation (C). I.R.C. § 338 (d)(3). "Purchase" is defined in § 338(h)(3).

\textsuperscript{57} See I.R.C. § 338(c)(2).


\textsuperscript{59} The "consistency period" begins one year before the first stock purchase which is part of the "qualified stock purchase" of a (target) corporation (see supra note 56), and ends one year after the first day on which there is a "qualified stock purchase" of such (target) corporation. I.R.C. § 338(h)(1), (2), (4).

\textsuperscript{60} The deemed election will eliminate the § 311(d)(1) gain unless the property has increased in value since the "qualified stock purchase" or recapture potential
above. These distinctions are not likely to be of great importance here. Such distributions will usually be taxed under section 301 as dividends to P (in whatever form actually made) just as would any other distribution to P. In this respect, taxing distributions to P will produce the anomalies associated with any plan 3 transaction.

Impact of Case Law on Taxation of Bootstrap Stock Acquisitions

The first part of this article reviewed the three principal alternatives for structuring a bootstrap stock acquisition. Absent contrary judicial gloss or Service interpretation, each of these alternatives results in the particular tax consequences explained above. The Service and the courts, however, often tax a transaction structured in one form as if it has been structured in another form. This part of this article examines Service and judicial recharacterizations of bootstrap stock acquisitions for tax purposes, concluding generally that such recharacterizations have proven inappropriate.

Current law does not tax all bootstrap stock acquisitions identically. The parties are free, within limits, to choose among the three alternatives and their associated tax consequences in structuring a bootstrap stock acquisition. The limits on this planning freedom derive from tax law principles familiar only to tax law experts and, in some contexts, not


See supra notes 41–43, 48, 51–52 and accompanying text.

See supra text accompanying notes 32–33 (plan (3) described).

Cf. I.R.C. §§ 636(a) (treating all carved out production payments as mortgage loans), 302(d) (treating redemptions economically like dividends as dividends for tax purposes).

A substantial literature exists on the planning aspects of this subject. See, e.g., J.C. Fleming, Tax Aspects of Buying and Selling Corporate Businesses, §§ 5.01–5.06 (1984); Freling, The “Boot-Strap” Purchase: Sections 302, 304, and 337; Reorganizations and Reincorporations, 24 N.Y.U. TAX INST. 1229 (1966); Graham, Redemption Problems—The Holsey and Zipp Cases, 36 TAXES 925 (1958); Horwood, Clarified IRS Position Enhances Planning For Stock Redemptions With New Shareholders, 46 J. TAX'N 338 (1977); Lange, Bootstrap Financing: The Redemption Technique, 18 TAX L. REV. 323 (1963); Polasky,
entirely clear even to those experts. Hence, although all three alternative structures for a bootstrap stock acquisition remain available to meticulous, well-informed tax planners, some acquisitions implemented pursuant to one type of plan may be taxed as if implemented otherwise. In particular, S-Dividend Plan or S-Redemption Plan acquisitions are often recharacterized and taxed as P-Dividend Plan acquisitions.

To understand how this has occurred, it is important to emphasize that it is of no concern to S whether its stock in C is acquired pursuant to an S-Redemption Plan as opposed to a P-Dividend Plan. In both cases, S will have the same capital gain as a result of the bootstrap stock acquisition. From S's point of view, then, an attempt by the Service to recharacterize an S-Redemption Plan acquisition as a P-Dividend Plan acquisition honors the form of the transaction. The form of the transaction, however, is thereby only recognized as to S. The recharacterization completely changes the tax treatment of P and C.

Furthermore, a dividend distribution to S as part of an S-Dividend Plan acquisition is generally taxed as a dividend by the courts, but not necessarily as a dividend to S. Such an S-Dividend Plan acquisition may instead be treated as a P-Dividend Plan acquisition, taxing P on the dividend and treating it as part of P's purchase price for S's stock. Again, the form of the bootstrap stock acquisition is honored in such a case, but only in part.

The current tax treatment of bootstrap stock acquisitions deviates from full recognition of a taxpayer's chosen form for the acquisition in three different, albeit not necessarily mutually exclusive, situations.

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65 See supra text accompanying notes 4–8 and 20–21.
66 See, e.g., Wilson v. Commissioner, 27 T.C. 976 (1957) (rejecting a seller's attempt to recharacterize a dividend distributed after he agreed to sell his stock as part of the purchase price), aff'd per curiam sub nom. Estate of Wilson v. Commissioner, 255 F.2d 702 (5th Cir. 1958). It is doubtful that arguing that the dividend was really a redemption would have led to a different result. See Reitz v. Commissioner, 61 T.C. 443 (1974), aff'd per unpublished opinion (5th Cir., Jan. 23, 1975) (dividend declared and paid immediately before gift of all stock to government agency; redemption treatment rejected because redemption neither occurred nor contemplated); cf. Television Industries, Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960) (similar rejection where redemption occurred on same day as sale); Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955) (redemption of stock from purchaser two years after stock acquisition; purchaser attempt to recharacterize as part of bootstrap stock acquisition on plan 1 model rejected). But see Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970) (presale dividend to corporate seller, recharacterized as part of purchase price at Service's behest), cert. denied, 401 U.S. 939 (1971).

67 P and S may not agree on the form of the transaction and, for this reason,
The legal rules applied in these situations have the usual effect of treating an S-Dividend Plan or an S-Redemption Plan acquisition as a P-Dividend Plan acquisition—a constructive dividend to P which becomes part of P's purchase price for the stock purchased from S and produces a capital gain to S. Although the courts have not been particularly clear in stating or applying these legal rules, the rules may be stated as tests in summary form:

(1) Did the distribution to S pursuant to an S-Dividend Plan or an S-Redemption Plan relieve P of a primary and unconditional contractual obligation pro tanto to purchase the C stock from S? This test (the "primary unconditional obligation test") has been most fully developed in S-Redemption Plan cases where the black letter rule may be stated this way: If, prior to the redemption, P has agreed to purchase the redeemed C stock and was at the time of the redemption primarily and unconditionally liable to make that purchase, the redemption is treated as a constructive dividend to P, and as an additional part of P's purchase price for S's stock in C. See The transaction is thus treated as if implemented pursuant to a P-Dividend Plan. The advantages and disadvantages of such a test are generally the same regardless of whether a dividend or redemption is involved, and no attempt will be made to separately discuss the test's application in the two contexts.

(2) Was P the beneficial owner of the stock when the dividend was declared? This test is referred to hereinafter as the "beneficial ownership test."

(3) Did the dividend result in a reduction in corporate net worth as an integral part of a bootstrap stock acquisition plan, the economic substance of which was a purchase of S's stock? This test, for want of a better designation, is referred to hereinafter as the "economic substance test."

An affirmative answer to any of these tests has led to treating P as the recipient of a constructive dividend and treating the amount of this constructive dividend as an additional part of the purchase price received by S on the sale of his stock, thus producing capital gain to S. Although an affirmative answer to the first test has usually preempted application of the other two tests, the three tests are not neces-

or through inadvertence, may structure their bootstrap stock acquisition in a form which is ambiguous, causing further unrelated difficulties in taxing it. One of the advantages of taxing all bootstrap stock acquisitions similarly would be to eliminate the potential for such ambiguity. This advantage could also be achieved, of course, by requiring the parties to file a joint election as to the tax characterization of their transaction. See infra text accompanying notes 188–89.

sarily consistent, and their overlapping application has created substantial uncertainty in the law. In any event, the cases and rulings have been extensively reviewed elsewhere and will be discussed here in an attempt to analyze and evaluate the current state of the law, rather than to reconcile or justify the diverse results found therein.

Part of the current unsatisfactory state of law derives from the fact that S's preferred alternative for structuring a bootstrap acquisition depends on whether S is an individual or a corporation. Thus, a corporate S prefers the S-Dividend Plan, pursuant to which it receives part of its consideration as a dividend for which a section 243 dividends received deduction is available, or which may be eliminated from income under the consolidated return regulations. An individual S, on the other hand, prefers the capital gain treatment associated with a sale pursuant to a P-Dividend Plan or a redemption pursuant to an S-Redemption Plan. Hence, S's desired treatment and S's position in litigation have depended on whether S has been a corporation or an individual. Similarly, the legal position of the Service has varied (inversely, in effect) with S's status. This situation, here as elsewhere, has not led to the development of consistent, easily applied tax rules. In particular, the tendency of the Service to argue for the application of different legal standards in essentially similar bootstrap stock acquisition cases (presumably justified as protecting revenue), when coupled with the taxpayer's burden of proof and the associated credence that sometimes seems to attach to government legal theories in tax cases, has produced confusion and essentially irreconcilable conflicts of legal principle.

In any event, the principal purpose served by these three tests is to

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70 See supra text accompanying notes 32–35.
71 See supra notes 15–16 and 26 and accompanying text.
72 See supra notes 4–7 and 11–14 and accompanying text.
73 Since the P-Dividend Plan usually offers no significant advantage to P over whichever of the other alternatives is involved, P's status has not played as large a role in the development of the case law.
74 Compare Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (successful Service argument that presale dividend to corporate seller was part of purchase price), and TSN Liquidating Corp., Inc. v. United States, 624 F.2d 1328 (5th Cir. 1980) (unsuccessful Service argument to same effect as to in-kind dividend), with Casner v. Commissioner, 450 F.2d 379 (5th Cir. 1971) (unsuccessful Service attempt to characterize presale distribution as a dividend to an individual seller; held, part of sales proceeds), and Rev. Rul. 75–493, 1975–2 C.B. 109 (Service will not follow Casner, distinguishing Waterman Steamship). For an argument that courts should require consistency from the Service, see Zelenak, Should Courts Require the Internal Revenue Service to Be Consistent?, 40 Tax L. Rev. 411 (1985).
characterize a distribution to S, in the form of a redemption or dividend, as a constructive dividend to P. An evaluation of these tests suggests that constructive dividend treatment is not generally justified by any of the rationales offered as supporting the use of the three tests. This in turn raises the question whether the P-Dividend Plan model is an appropriate model for taxing any bootstrap stock acquisition at all, even one implemented in the P-Dividend Plan form. This question and the more general question as to the appropriate tax treatment of all bootstrap stock acquisitions are reserved for discussion in the next part of this article.

Primary Unconditional Obligation Test

Application of the primary unconditional obligation test results in taxing an S-Redemption Plan transaction as if implemented according to the P-Dividend Plan model if P had a pre-existing primary and unconditional obligation to purchase the redeemed portion of S's stock. This result is justified by the notion that C's redemption of some of S's stock supposedly satisfies a debt of P by relieving S of his preexisting obligation. The current application of the primary unconditional obligation test in S-Redemption Plan situations is spelled out in Revenue Ruling 69–608.\(^{75}\)

In S-Dividend Plan situations, similar principles treat P as receiving a constructive dividend if the dividend distribution to S reduces the purchase price P was otherwise contractually obligated to pay for S's stock in C.\(^{76}\) This S-Dividend Plan version of the primary unconditional obligation test has not produced the spate of case law that the redemption version of the test has produced. This probably results from two factors: (1) The formal presence of a dividend to S in dividend cases means the Service is not under pressure to prevent an individual S from converting a distribution of C's earnings and profits into redemption-generated capital gain;\(^{77}\) and (2) a corporate S is likely to be more sophisticated and to have taken steps to avoid running afoul of the extremely formalistic primary unconditional obligation test; as a result, the test has been irrelevant in attempts by the Service to treat a formal dividend to a corporate S as a constructive dividend to P. These factors have led to application of the other two tests in S-Dividend Plan situations.

\(^{75}\) 1969–2 C.B. 43.

\(^{76}\) See Miller v. Commissioner, 247 F.2d 206 (7th Cir. 1957) (dividend declared same day contract signed; rationale for decision ambiguous), cert. denied, 355 U.S. 939 (1958); Estate of Hobson v. Commissioner, 17 T.C. 854 (1951), acq. (dividends paid to seller who held stock as security for payment of purchase price credited against purchase price under terms of contract).

\(^{77}\) If the purchaser and seller take inconsistent positions as to whose dividend the distribution is, the Service must litigate as a stakeholder. This is what happened in the two cases cited in note 76; the seller and purchaser were in court in a consolidated case in each instance.
An evaluation of the primary unconditional obligation test must begin at the test's apparent source, *Wall v. United States.*78 The court in *Wall* held that a corporation's discharge of a shareholder's obligation to pay for stock of the corporation which the shareholder had previously acquired was taxable to the shareholder as a dividend even though the shares so purchased were redeemed as part of the transaction. The court explained its decision by noting that the corporation's discharge of the shareholder's indebtedness constituted a corporate distribution made for the benefit of the shareholder. That is, the court in *Wall* treated the case as analogous to any situation in which a corporation pays a debt of its shareholder, the payment of the shareholder debt being the equivalent of a cash distribution to the shareholder.79 So viewed, the result in *Wall* was perfectly sensible.

The *Wall* decision's application, of course, depended on whether the shareholder had actually acquired the redeemed stock so that he could be characterized as the owner of the stock and, hence, indebted to the extent of any unpaid purchase price at the time the corporation discharged his indebtedness in the process of redeeming the stock. As a result, cases subsequent to *Wall* attached great significance to who (seller or purchaser-continuing shareholder) actually transferred the redeemed shares to the corporation. Where the seller had his shares redeemed directly by the corporation, the S-Redemption Plan form was generally honored and the purchaser (or continuing shareholder) was not treated as receiving a constructive dividend.80 Where the purchaser or continuing shareholder owned the shares prior to their redemption, as in *Wall,* the purchaser or continuing shareholder was generally treated as receiving a constructive dividend as a result of the redemption.81

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78 164 F.2d 462 (4th Cir. 1947).
81 *See* Television Industries, Inc. v. Commissioner, 284 F.2d 322 (2d Cir. 1960)
structive dividend result in the latter group of cases, however, seemed harsh to a purchasing or continuing shareholder. On occasion, such a shareholder was able to avoid this result by establishing that his intermediate acquisition of the subsequently redeemed shares was made as an agent of the corporation, and that the corporation in substance redeemed the seller's stock.\footnote{32}

Despite the results in these cases, the Commissioner sought in a few instances to extend the \textit{Wall} rationale to instances where a redemption discharged a purely executory obligation of the purchasing or continuing shareholder to purchase the redeemed stock. Initially, the Commissioner met with little success in this effort,\footnote{33} but later efforts proved more successful, culminating in the landmark decision of \textit{Sullivan v. United States}.\footnote{34} Sullivan, who owned 62\% of a corporation's stock, (redemption and sale on same day); \textit{Zipp v. Commissioner}, 259 F.2d 119 (6th Cir. 1958) (corporation paid father for 48 shares, 46 of which had been previously transferred to continuing shareholder-sons as "nominees;" simultaneously with redemption of all 48 shares, father agreed he had no right or interest in the 46 shares; held, constructive dividend to sons, apparently overlooking actual redemption of father's other two shares), \textit{cert. denied}, 359 U.S. 649 (1959); \textit{Woodworth v. Commissioner}, 218 F.2d 719 (6th Cir. 1955) (redemption two years after stock acquisition). \textit{Cf. Schalk Chem. Co. v. Commissioner}, 304 F.2d 48 (9th Cir. 1962) (purchaser had apparently acquired beneficial ownership but not legal title).

\footnote{32} The leading case in this vein was \textit{Fox v. Harrison}, 145 F.2d 521, 522 (7th Cir. 1944) (stock acquired "on behalf of the corporation . . . as a temporary expedient"). \textit{See also Green v. Commissioner}, 22 T.C.M. (CCH) 1241 (1963). A similar line of cases telescoped the purchaser-continuing shareholder stock purchase and redemption, viewing the corporation as simply redeeming the selling shareholder's shares. These cases sound like agency cases, although they are not couched in agency terminology. \textit{See Peterson v. Commissioner}, 23 T.C.M. (CCH) 63 (1964) (following \textit{Fox v. Harrison and Decker, infra}); \textit{McShain v. Commissioner}, 22 T.C.M. (CCH) 1611 (1963) (similar to \textit{Decker}; financing of acquisition planned to be from corporate sale of certain property); \textit{Decker v. Commissioner}, 32 T.C. 326, 333 (1959), \textit{nonacq.} ("resale to the corporation was obviously a part of a plan"), \textit{aff'd per curiam}, 286 F.2d 427 (6th Cir. 1960).

\footnote{33} \textit{See McShain v. Commissioner}, 22 T.C.M. (CCH) 1611 (1963); \textit{Decker v. Commissioner}, 32 T.C. 326 (1959), \textit{nonacq.}, \textit{aff'd per curiam}, 286 F.2d 427 (6th Cir. 1960). \textit{See also Goss v. Commissioner}, 22 T.C.M. (CCH) 1219 (1963); \textit{Priester v. Commissioner}, 38 T.C. 316 (1962) (unsuccessful Service attempt to (1) ignore sale of shares to purported strawman who then gave option to corporation to redeem shares and (2) treat series of transactions as dividend to previously obligated purchaser-continuing shareholder upon corporation's exercise of option; strawman held to be bona fide investor).

\footnote{34} 363 F.2d 724 (8th Cir. 1966), \textit{cert. denied}, 387 U.S. 905 (1967). \textit{See also Schalk Chem. Co. v. Commissioner}, 32 T.C. 879 (1959), \textit{aff'd}, 304 F.2d 48 (9th Cir. 1962). The dispute in \textit{Schalk Chemical} seemed to center on whether the continuing shareholders were in fact obligated to purchase the redeemed stock or instead had mere options to purchase the redeemed stock; hence, it is unclear whether the merits of the legal doctrine applied in the case were fully argued. For a more recent case slavishly accepting \textit{Sullivan} over the taxpayer's objection, see \textit{Smith v. Commissioner}, 70 T.C. 651 (1978).
was obligated to purchase the 38% of the stock owned by his manager, Nelson, if Nelson offered Sullivan the stock. Sullivan, however, responded to Nelson's offer of the stock by having the corporation redeem Nelson's stock. At no time in the transaction did Sullivan own the shares so redeemed, either legally or beneficially. Hence, Sullivan's situation differed from that of Wall, who had actually owned the stock there redeemed. Nonetheless, the Eighth Circuit affirmed the district court decision that the redemption constituted a constructive dividend to Sullivan on the theory that the redemption resulted in an "economic benefit" to Sullivan because "he was relieved of his personal obligation to purchase Nelson's stock."85 The court apparently thought the situation analogous to a corporation's payment of a shareholder's preexisting indebtedness, the situation involved in Wall.86 Strangely enough, given the importance of the issue, the Court of Appeals in Sullivan offered no explanation and cited no authority (not even Wall, which had been cited as controlling authority by the district court)87 for the legal principle that Sullivan is regarded as establishing.88

In any event, Sullivan did not involve a discharge of a preexisting shareholder indebtedness, and the analogy between such a discharge of indebtedness and the Sullivan corporation's assumption of Sullivan's purely executory obligation is false. In the latter case, the corporation makes no distribution to the shareholder. When a corporation assumes a shareholder's obligation to purchase property other than the corporation's own stock at a price equal to the property's fair market value, the corporation distributes nothing of value to the shareholder that could constitute a dividend.89 Rather, the corporation assumes both the shareholder's obligation to pay for the property and the shareholder's presumably equal offsetting right to receive the property pursuant to the purchase agreement; no value passes to the shareholder. A corporate assumption of a shareholder's obligation to purchase stock of a corporation at a price equal to its fair market value should stand on the same footing: The corporation assumes the obligation to pay for the stock and the right to receive the stock. Although a

85 363 F.2d at 729.
86 164 F.2d 462 (4th Cir. 1947).
88 An examination of both opinions in Sullivan reveals the principal dispute to have been a factual one as to whether Sullivan was in fact obligated to purchase Nelson's stock at the time of the redemption, rather than a dispute as to the effect of such an obligation for tax purposes.
89 Easson v. Commissioner, 294 F.2d 653 (9th Cir. 1961) (payments on mortgage notes secured by corporate property but on which shareholder was personally liable); Citizen's Bank & Trust Co. v. United States, 580 F.2d 442 (Ct. Cl. 1978) (per curiam).
corporation's acquisition of its own stock differs from an acquisition of property because the latter does not affect the corporation's net worth while the former involves a reduction in net worth accompanied by a change in the corporation's capital structure, the impact on a shareholder whose obligation to make either acquisition was assumed by the corporation is the same. No value is distributed by the corporation to the shareholder and no dividend should result.

The impropriety of Sullivan's equating an executory obligation and a preexisting debt may be illustrated by example. If a corporation pays a shareholder's $2,000 credit card balance, the payment will increase the shareholder's ex-corporate net worth by $2,000, the amount by which the shareholder's liabilities are thus reduced. This is so because the shareholder retains the benefit of the credit card charges (for instance, new clothing or furniture) while the corporation discharges the shareholder's obligation to pay for these items. By contrast, if C instead redeems stock from S for $2,000, thereby relieving P of an obligation to buy the redeemed S stock, a different result follows. If P was obligated to buy S's stock in C at a price reflecting its fair market value and the reduction in P's obligation as a result of the distribution to S fairly reflects the amount of the distribution, C's distribution has no effect on P's ex-corporate net worth. P retains no measurable benefit

90 See generally Manning, The Issuer's Paper: Property or What? Zero Basis and Other Income Tax Mysteries, 39 TAX L. REV. 159 (1984). The change in capital structure amounts to a cancellation of the corporation's "liability in form" to the redeemed selling shareholder, a transaction effectively treated by § 302(a) as an acquisition of property by the corporation and a sale of property by the shareholder. See infra text accompanying notes 93–95.

91 This point was made by the Tax Court in an earlier case:

While petitioners may have been obligated to purchase the stock of a deceased stockholder, this is a different sort of obligation from those in [Wall]. . . . Petitioners' obligation here was to purchase stock for its book value. Presumably, the stock was worth what was paid for it. Had petitioners bought and retained the stock, their net worths would have remained the same. The corporation did not pay a preexisting debt of the petitioners, the satisfaction of which would increase their net worths. They realized no economic benefit from the transaction.


92 The two posited situations differ in their impact on P's ex-corporate net worth, not in their impact on P's total net worth. This reflects the true nature of a dividend. In general, assuming the value of a corporation's stock accurately reflects the underlying value of the corporation's assets (an assumption not borne out by the volatility of prices for shares of stock in publicly held companies), the distribution of a dividend does not affect the shareholder's aggregate net worth. The value of the shareholder's stock in the corporation declines by the amount of the distribution, thus offsetting the increase in the value of the shareholder's assets
when C thus redeems S's stock. Although P's percentage ownership of C may increase, this percentage increase is exactly offset in terms of the value of P's interest in C by the fact that the total value of C is reduced by the transaction. To treat P as receiving a constructive dividend in these circumstances, when C has distributed nothing out of the corporate solution to P, is to elevate form over substance.

In one sense, C's redemption from S of stock which P was otherwise obligated to purchase is analogous to C's distribution of a dividend. Both involve a reduction in corporate assets by way of a transfer of corporate assets out of corporate solution. Moreover, a distribution of corporate assets out of corporate solution to a shareholder's personal ex-corporate asset base is a necessary incident of a dividend. It is not, however, the only necessary incident of a dividend, a fact that follows ineluctably from the nondividend status of many redemption and liquidation distributions. In addition to a distribution of corporate assets out of the corporate solution, a dividend presupposes that the corporation has transferred the assets to or for the economic benefit of the shareholder treated as the dividend recipient and that the corporation is not treated as receiving a quid pro quo in return.\(^93\) Neither of these other dividend incidents is present in the Sullivan redemption. The distribution of assets goes to the redeemed shareholder, S, not to P who is treated as receiving the constructive dividend; as explained above, any purported economic benefit to P from the distribution is strictly illusory. Furthermore, in return for the corporation's distribution to S, the corporation's liability in form to S is cancelled with respect to the redeemed shares.\(^94\) While the cancellation of this liability in form is not a true economic benefit to the corporation, section 302(a) effectively treats the cancellation as a quid pro quo for the redemption distribution in calling for sale or exchange treatment of redemptions, rather than dividend treatment.\(^95\) Thus, a true redemption of one shareholder's stock, S, at

\(^93\) See Lang, A Theory of Constructive Dividends (tentative title) (draft manuscript), Part II, The Nature of Dividends under the Income Tax.

\(^94\) For the characterization of the corporate-shareholder relationship as creating a liability in form from the corporation to the shareholder, see Eisner v. Macomber, 252 U.S. 189, 209 (1920).

\(^95\) Section 302(b)'s nondividend equivalence standards represent an attempt to distinguish cases in which the cancellation of this liability in form is meaningful from cases in which the cancellation of this liability in form is not meaningful. See infra notes 214–16 and accompanying text; Lang, supra note 93. Systems have been proposed in which redemption proceeds, and even liquidation proceeds, would be treated as dividends to shareholders to the extent of the shareholders' pro rata shares of earnings and profits, in which earnings and profits would be
a price equal to the redeemed stock's fair market value, should not be treated as a constructive dividend to another shareholder, P.

The unsoundness of the Sullivan result is further confirmed by the fact that it is accompanied by an individual P receiving a basis in the stock of C which far exceeds the stock's fair market value.\(^{98}\) For example, assume P contracted to acquire 100% of C from S for its fair market value of $10,000. Instead, P purchases 40% of S's stock in C for $4,000, and C redeems S's remaining stock for $6,000. Under Sullivan, the redemption results in a constructive dividend to P of $6,000 (assuming sufficient earnings and profits). This $6,000 then becomes part of P's purchase price for S's stock in C, giving P a total basis of $10,000 in his C stock. The $6,000 redemption, however, also reduces C's net worth by $6,000 to $4,000. Hence, P has a basis of $10,000 in stock worth $4,000. There is no justification for continuing a rule of law which gives P a basis of $10,000 for an asset acquired for $4,000. That

allocated and taxed to shareholders annually, or in which nondividend distributions would be discouraged by various means. See generally Doernberg, The Taxation of Reinvested Corporate Earnings, 24 WM. & MARY L. REV. 1 (1982); ALI, FEDERAL INCOME TAX PROJECT, SUBCHAPTER C: PROPOSALS ON CORPORATE ACQUISITIONS AND DISPOSITIONS AND REPORTER'S STUDY ON CORPORATE DISTRIBUTIONS 401–86 (1982) (proposing an excise tax on nondividend distributions) [hereinafter cited as ALI]; Chirelstein, Optional Redemptions and Optional Dividends: Taxing the Repurchase of Common Shares, 78 YALE L.J. 739 (1969) (proposing that redemptions by public tender offer be taxed as (1) pro rata dividends followed by (2) intershareholder sales). However, the current system generally bears little resemblance to such proposals.

In the Canadian income tax system, a redemption by a private corporation is treated as a deemed dividend to the extent the amount distributed exceeds the paid-up capital in respect of the shares redeemed. Canadian Income Tax Act § 84(3), Can. Rev. Stat. ch. 148 (1952). If the shareholders' cost for the shares exceeds their paid-up capital, the difference is treated as a capital loss. Id. at § 54(h)(x). See K. LAHEY, CORPORATE TAXATION 372–73 (1984). These rules are, of course, subject to the usual tax system complexities, such as special provisions applicable to corporate shareholders and dividend gross-up provisions. In addition, redemptions by public corporations are taxed differently under the Canadian Income Tax Act. See generally K. LAHEY, CORPORATE TAXATION 365–77 ff. (1984). I am indebted to Associate Dean NORMAND RATTI of the University of Sherbrooke Faculty of Law for aiding my limited understanding of the Canadian system of taxing corporations and shareholders. For another perspective, see Clark, The Morphogenesis of Subchapter C: An Essay in Statutory Evolution and Reform, 87 YALE L.J. 90, 108–10 [hereinafter cited as Clark] (administrative problem of allocating earnings and profits to all shareholders and taking allocations into account on all distributions of property or sales of stock).

\(^{98}\) A corporate P which does not file a consolidated return with C for the taxable year in which the constructive dividend is distributed would also be likely to end up with an unrealistically high basis in the stock of C. See supra text accompanying note 32. However, when P is a corporation, constructive dividend treatment under the primary unconditional obligation test is unlikely to arise in practice inasmuch as a constructive dividend to a corporate P would usually not generate much additional revenue because of the § 243 dividends received deduction.
the price of this $10,000 basis is the privilege of paying tax out of P’s other income, if any, on a constructive (phantom) dividend of $6,000, only adds to the absurdity. Furthermore, since the acquired asset is stock, which is not depreciable, the increased basis is effectively non-recoverable for tax purposes during P’s ownership of C. This, of course, is the economically unsound result that follows if the acquisition proceeds according to the P-Dividend Plan model, and counsels rejection of that model for taxing bootstrap stock acquisitions. Nonetheless, the possibility that the parties may inadvertently plan a transaction in a form which produces a tax result out of step with the transaction’s economics is no reason to extend the unsound tax treatment (through the primary unconditional obligation standard derived from Sullivan) to other forms in which the transaction may be implemented.

The crux of the problem, then, with the primary unconditional obligation test is that its application results in taxing two equivalent bootstrap stock acquisition transactions differently because of the irrelevant existence in one case, but not the other, of a prior executory contract between P and S. Indeed, the executory contract is never consummated to the extent of a corporate redemption or distribution which results in a constructive dividend to P because of the contract’s existence. Application of the primary unconditional obligation test does not reflect an informed judgment that constructive dividend treatment to P is appropriate in such transactions; instead, the test represents a mistaken judicial doctrine of dubious provenance.

Sophisticated tax planners could avoid the trap laid by Sullivan in a number of ways. For example, P could agree to either purchase S’s C stock or cause the stock to be purchased; if P later caused C to redeem the stock, no constructive dividend to P would result. Similarly, if S and P (in this case, necessarily a continuing shareholder) agreed that upon the death of either, the survivor would either purchase the decedent’s

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97 See supra text accompanying notes 20–31 (tax consequences of P-Dividend plan); infra text accompanying notes 206–10 (rejecting P-Dividend approach to taxing bootstrap stock acquisitions). Section 1059, discussed in notes 27–29 and accompanying text, is designed to deal with tax avoidance techniques based on the P-Dividend plan approach. See also I.R.C. § 246(e).

98 See Kobacker v. Commissioner, 37 T.C. 882 (1962), acq. (P agreed to acquire S’s stock but reserved right under contract to assign contract to a corporation; P assigned contract to a newly organized corporation which purchased stock and subsequently merged with original corporation; held, no constructive dividend); Fischer v. Commissioner, 6 T.C.M. (CCH) 520 (1947) (P obligated to “purchase or secure a third party to purchase”); S.K. Ames, Inc. v. Commissioner, 46 B.T.A. 1020 (1942), acq. In S.K. Ames, Inc., S was also free to sell the stock to a third party, but this does not seem to have been important. See also Enoch v. Commissioner, 57 T.C. 781 (1972), acq. (as to this issue) (post-Sullivan case where P had agreed that P or his nominee would purchase S’s stock).
stock from the decedent's estate or cause C to liquidate, P's causing C to redeem stock from S's estate would not result in a constructive dividend to P.99 In these cases, P had no fixed obligation to purchase S's stock at the time of the redemption of S's stock because P could, pursuant to the contract, cause some other disposition of S's stock, through a third-party purchase or a corporate liquidation. Sullivan could also be avoided by giving P a mere option to acquire S's stock under appropriate circumstances (if S were agreeable to such an arrangement) rather than requiring P to acquire S's stock100 or by having the corporation in the first instance agree to redeem and then actually redeem S's stock.101 Hence, for the most part, Sullivan simply created a trap for unwary taxpayers, those without tax counsel to advise them on how to structure a bootstrap stock acquisition with tax consequences paralleling their expectations.

Nor could planning to avoid the Sullivan result be regarded as tax avoidance: Most structures for achieving the pretax economic result achieved in Sullivan would result in S-Redemption Plan tax consequences.102 That is, Sullivan was the aberration.

These arguments were not entirely overlooked by the Service and the Treasury. After Sullivan was decided, the author understands that great concern was expressed in government circles about Sullivan's unsound rationale and the fact that the Sullivan result could easily be avoided, was therefore a trap for the unwary and, was, in effect, an aberration.103 Indeed, it was even suggested that Sullivan be given an administrative refund—that the Commissioner acknowledge that the position successfully argued in the Eighth Circuit was mistaken.104 Instead of such a radical about-face, however, the Commissioner issued Revenue Ruling 69–608,105 providing seven illustrations of when the Sullivan doctrine did and did not apply.

101 See supra note 82 and accompanying text.
102 See supra notes 2, 98–101 and accompanying text.
103 This information is derived from memoranda provided to me by ROBERT A. JACOBS from his personal files. Copies of these memoranda are on file with the author.
104 This did not happen. The author is unsure why, although the Joint Committee on Taxation apparently expressed misgivings on the subject. In any event, the Commissioner eventually decided to contest Sullivan's petition for certiorari, and did so successfully. 387 U.S. 905 (1967).
In one sense, Revenue Ruling 69–608 is unremarkable: It spells out the *Sullivan* doctrine and indicates how it can be avoided in the context of an acquisition of a retiring shareholder's stock through techniques such as those discussed above.\(^{106}\) Indeed, most tax attorneys plan with a goal of avoiding the creation of a situation on all fours with *Sullivan*.\(^{107}\) More interestingly, however, the ruling limits the application of the *Sullivan* doctrine to situations where the continuing shareholder\(^ {108}\) at the time of the redemption (or assignment of his contract to buy S's stock in the corporation) is subject to a primary and unconditional obligation to buy S's stock, thus precluding application of the doctrine to situations involving secondary or contingent obligations. In effect, then, the Commissioner, while not acknowledging that *Sullivan* was wrong, decided not to seek extension of its doctrine.

Unfortunately, even without any extension of the doctrine, the primary unconditional obligation standard derived from *Sullivan* has generated considerable difficulty and litigation. Its constructive dividend result is more likely to affect an unsuspecting *P*. The magnitude of this unexpected tax penalty leads the *P* victim to attempt to outwit the Commissioner. If *P* learns of the tax penalty before the *S* stock is redeemed, *P* may seek to rescind the ill-fated agreement obligating him to buy *S*'s stock and to substitute an agreement that will not impose upon him the fatal primary and unconditional obligation to purchase *S*'s stock. If the rescission predates the maturing of *P*'s obligation under the original agreement as a primary and unconditional obligation, this approach will preclude application of the *Sullivan* doctrine because *P* will at no time have been under a primary and unconditional obligation to purchase the subsequently redeemed stock of *S*.\(^ {109}\)

If *P* learns of the tax penalty after he is subject to a primary and unconditional obligation to purchase *S*'s stock but before the redemption has occurred, *P*'s planning options narrow. In some instances, *P* may be able to arrange for *S* to make a bona fide sale of the shares to a third party.\(^ {110}\) If the corporation soon thereafter redeems the stock from the third party pursuant to a prearranged plan, the transitory holding of the stock by the third party will probably be ignored, however, and *P* will

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\(^{106}\) Supra notes 98–101.

\(^{107}\) There is always the possibility that another Court of Appeals would refuse to follow *Sullivan*, but few lawyers are likely to be willing to test such a possibility in planning a transaction.

\(^{108}\) The ruling is primarily addressed at situations where remaining shareholders may agree to purchase a retiring shareholder's stock. Situation 6, however, involves an incoming purchasing shareholder.


\(^{110}\) See Goss v. Commissioner, 22 T.C.M. (CCH) 1219 (1963); Priester v. Commissioner, 38 T.C. 316 (1962), reviewed (3 dis.).
presumably be taxed as if the shares had been directly redeemed from S. Hence, this solution has not attracted a large following.

P might instead, prior to having C redeem S's stock, seek to rescind the agreement with S or to modify the agreement to eliminate either the primary or the unconditional aspect of the obligation. For example, the contract might be modified to permit S to assign it to a corporation.¹¹¹ Sullivan, itself, addressed this issue in a footnote:

The taxpayer makes an alternative argument to the effect that, even if he was unconditionally obligated to purchase Sullivan’s stock, subsequent events constituted a modification or novation of that agreement. Even if this contention is accepted, the court is at a loss as to how the taxpayer is aided. The novation or modification itself would be considered as resulting in an economic benefit and possible constructive dividend taxable against Sullivan. The taxpayer would be left in essentially the same position with respect to his possible tax liability.¹¹²

Although the economic benefit referred to is as illusory as that underlying the principal doctrine espoused in Sullivan, the persuasive authority of this footnote cannot be ignored. Indeed, the footnote was cited by Judge Tannenwald in a recent opinion in which he found it unnecessary to decide the issue because he concluded that P had not been released from his obligation to purchase S’s stock on the particular facts presented.¹¹³ While Judge Tannenwald suggested a modification of a contract might be effective to save a purchasing or continuing shareholder in some circumstances,¹¹⁴ the author is unaware of any case approving of such a result.¹¹⁵ Uncertainty in this area is likely to lead to further

¹¹¹ P’s obligation to purchase S’s stock would then not be unconditional. See cases cited supra note 98.
¹¹³ Jacobs v. Commissioner, 41 T.C.M. (CCH) 951, 953 (1981), aff’d per curiam, 698 F.2d 850 (6th Cir. 1983).
¹¹⁴ Judge Tannenwald mentioned this as a possibility in a context in which a seller-instigated contractual modification is supported by independent consideration and in which the corporation and the seller have a “legitimate” purpose. Id. at 953–54. The author is extremely skeptical that such a situation will ever arise, particularly since it is generally of no concern to the seller what the source of his payments is; hence, the seller is unlikely to instigate a contractual modification.
¹¹⁵ See Smith v. Commissioner, 70 T.C. 651, 669 (1978) (rejecting argument that new agreement which changed terms of purchase as well as nature of taxpayer’s obligation relieved taxpayer of obligation to purchase stock, thus preventing application of Sullivan doctrine per unconditional obligation under old agreement). Cf. Edler v. Commissioner, 727 F.2d 857, 859–60 (9th Cir. 1984) (obligation under divorce decree to pay for wife’s interest in stock awarded to taxpayer modified by divorce court in nunc pro tunc order to provide for redemption of stock from wife; held, no constructive dividend since divorce court exer-
litigation as long as the primary unconditional obligation test receives continued judicial endorsement.

If $P$ learns of the *Sullivan* constructive dividend after the redemption of $S$'s stock, $P$ cannot restructure the transaction, but may instead argue that he was never actually obligated to purchase $S$'s stock because (1) he possessed a mere option, (2) the corporation was the party obligated to purchase the $S$ stock, or (3) there was no contract. Most disputes based on such arguments are easily resolved by an examination of the documents executed by the parties.\textsuperscript{116} Nonetheless, these disputes and the resulting litigation are a direct by-product of the continued viability of the primary unconditional obligation standard.

Litigation also arises when a surprised $P$ claims that what appeared to be $P$'s primary and unconditional obligation to purchase $S$'s stock was actually entered into by $P$ as agent for $C$ rather than in $P$'s personal capacity. The courts, however, look askance at such claims unless $P$ can explain why $C$'s redemption of $S$'s stock required $P$ to agree to acquire the stock in the first instance.\textsuperscript{117} Indeed, even in the litigated cases such claims often represent little more than desperate attempts to avoid the *Sullivan* doctrine.\textsuperscript{118} One can only speculate as to how tenuous

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\textsuperscript{117} See Peterson v. Commissioner, 23 T.C.M. (CCH) 63 (1964) (time constraints necessitated contract with petitioner as sole signatory, although he really represented several parties, including the corporation); Green v. Commissioner, 22 T.C.M. (CCH) 1241 (1963) (corporation had insufficient surplus to purchase stock outright at time of contract); see also State Pipe & Nipple Corp. v. Commissioner, 46 T.C.M. (CCH) 415 (1983) (strong proof adduced to show that contract did not reflect intention of the parties that corporation was in reality acquiring (that is, redeeming) stock).

\textsuperscript{118} See Schalk Chem. Co. v. Commissioner, 304 F.2d 48 (9th Cir. 1962) (Tax Court not convinced of necessity or desirability of transaction from corporate point of view), aff'd 32 T.C. 879 (1959); McKeown v. Commissioner, 39 T.C.M. (CCH) 917, 920–21 (1980) (taxpayer not pressured by seller or financing bank to acquire stock personally; evidence that agency argument was afterthought); Stephens v. Commissioner, 60 T.C. 1004, 1013 (1973) (no good explanation for structure of transaction), aff'd mem., 506 F.2d 1400 (6th Cir. 1974); Miles v.
\end{footnotesize}
a typical claim made at the audit or administrative appeal level is. In one sense, situations in which P claims to have acted as agent for C in agreeing to buy S's stock are analogous to and often overlap situations in which P claims to have actually acquired S's stock as agent for C. For the former area of uncertainty and dispute, however, is traceable entirely to the Sullivan doctrine as manifested in the primary unconditional obligation test. Given the infirmities of the primary unconditional obligation test, it bears emphasizing that constructive dividends may arise in two other contexts when C assumes an obligation of P in connection with P's agreement to purchase S's stock. First, C may make payments on an installment note given by P to acquire S's stock. Since P has then acquired the C stock in question, C's payments relieve P of P's obligation to pay for the stock and, to this extent, C has distributed assets to P. Constructive dividend treatment in such a case is appropriate;

Commissioner, 25 T.C.M. (CCH) 1278, 1282–83 (1966) (no evidence to support claim that corporation intended to redeem the stock). One can only speculate on the number of cases involving similarly frivolous agency arguments that were settled before actually going to trial.

For cases accepting such claims in the latter situations, see note 82. See also Hargleroad v. United States, 202 F. Supp. 92, 95 (D. Neb. 1962) (circuitous route used for redeeming shareholder's personal reasons); Bennett v. Commissioner, 58 T.C. 381 (1972), acq. (seller insisted for corporate law reasons on structuring redemption as distribution to taxpayer who then paid for stock; taxpayer held to be conduit); Ciaio v. Commissioner, 47 T.C. 447 (1967), acq. (redemption plan restructured as sale through taxpayer (continuing shareholder) to corporation in order to satisfy requirements of banks for agreeing to finance transaction; taxpayer held to be agent of corporation). But see Santulli v. United States, 38 A.F.T.R.2d 5869 (D. Md. 1976) (seller insisted on structuring transaction as sale followed by redemption from purchaser to avoid increase in seller's taxes from termination of subchapter S election; held, taxpayer-purchaser could not ignore agreement to obtain more favorable tax treatment). Santulli is distinguishable from Ciaio, Bennett, and Hargleroad because tax considerations played a major role in at least the seller's approach to structuring the Santulli transaction, and, arguably, the courts should not permit a seller and a purchaser to characterize a single transaction in conflicting ways for tax purposes at the Commissioner's expense. Cases rejecting agency arguments on less promising facts are numerous, including the leading case of Wall v. United States, 164 F.2d 462 (4th Cir. 1947). See also Lowenthal v. Commissioner, 169 F.2d 694, 699–700 (7th Cir. 1948); Adams v. Commissioner, 69 T.C. 1040, 1046–47 (1978), aff'd, 594 F.2d 657 (8th Cir. 1979) (court questioned taxpayer's authority to act as agent); Estate of Freeman v. Commissioner, 23 T.C.M. (CCH) 1893, 1894 (1964); Silverman v. Commissioner, 13 T.C.M. (CCH) 527, 531 (1954) (taxpayer offered to sell corporation as many of purchased shares as corporation wished to buy).

A uniform approach to the taxation of bootstrap stock acquisitions could also reduce the litigation over agency issues when P actually acquires S's stock prior to having it redeemed by C. This could be done by treating P-Dividend Plans as S-Redemption Plans for tax purposes if the distribution to P (in form of a redemption or a dividend) took place within a certain period of time of P's acquisition of S's stock. See infra text accompanying notes 229–54.
whether $C$ is a co-maker or guarantor of the note should be irrelevant if $P$ has received the stock.\textsuperscript{121} There may be factual difficulty in distinguishing this kind of case from a case involving $C$'s assumption of a wholly executory contract,\textsuperscript{122} but the real issue will always be whether $P$ actually acquired the stock involved.\textsuperscript{123} In any event, $P$ may sometimes be able to avoid constructive dividend treatment in the situation involving assumption of actual stock acquisition indebtedness by contributing the $C$ stock to a newly organized holding company which assumes $P$'s stock acquisition indebtedness to $S$.\textsuperscript{124}

In this connection, it is worth noting one commentator's attempt to explain the Sullivan doctrine by analogizing the situation to which it applies to $C$'s payment of $P$'s debts incurred by $P$ on the purchase of $S$'s stock.\textsuperscript{125} This explanation is founded on extension of a principle supposedly underlying the well-known decision in Commissioner v. Court

\textsuperscript{121} See e.g., Yelenics v. Commissioner, 74 T.C. 1513 (1980), acq. (co-maker); McKeown v. Commissioner, 39 T.C.M. (CCH) 917 (1980) (guarantor). $P$'s surrender of the stock to $C$ should also be irrelevant if the redemption would otherwise be essentially equivalent to a dividend under § 302. This is what happened in Wall v. United States, 164 F.2d 462 (4th Cir. 1947).

\textsuperscript{122} Sometimes, for example, the contract is signed and partially executed at the same time, or a substantial downpayment and an escrow arrangement allowing the purchaser to vote the stock may create an ambiguous situation.

\textsuperscript{123} Dividend treatment to $P$ upon $C$'s making of payments on an installment note given by $P$ to acquire $S$'s stock may result in $P$ having a basis in his $C$ stock in excess of the stock's fair market value; whether this happens depends on the extent to which $C$ makes the installment payments out of post-acquisition earnings or appreciation. Nonetheless, if $P$'s basis ends up exceeding the fair market value of his $C$ stock, it is because he originally received a fair market value cost basis in the stock on its acquisition and then reduced the original acquisition date net worth of the corporation by causing the corporation to make subsequent distributions to pay $P$'s installment obligations. This is analogous to the diminution in the value of corporate stock which results from the usual dividend distribution, which if covered by earnings and profits does not reduce the shareholder's basis in his stock. By contrast, constructive dividend treatment upon application of the primary unconditional obligation test gives $P$ a basis in his $C$ stock which exceeds the stock's fair market value ab initio.

\textsuperscript{124} See I.R.C. § 304(b)(3)(B). $C$ would presumably finance the holding company's payment of the debt by distributing dividends to the holding company. The cited portion of § 304 may be read as subjecting the assumption of acquisition indebtedness part of the transaction to §§ 351 and 357 as opposed to § 304, a result which might turn the constructive dividend into a lesser amount of immediately taxable capital gain. However, Congress does not seem to have intended this result. See CONF. REP. No. 760, 97th Cong., 2d Sess. 542 (1982), reprinted in 1982–2 C.B. 600, 635. Hence, the possibility of avoiding immediate taxation altogether seems to remain, although the obvious tax avoidance involved may limit the possibility's practical applications. An analysis of these issues is beyond the scope of this article. See generally Cromwell Corp. v. Commissioner, 43 T.C. 313 (1964), acq. (bootstrap acquisition accomplished through use of holding company did not run afoul of § 269).

\textsuperscript{125} Kingson, supra note 69, at 881–84.
Holding Co. to bootstrap stock acquisitions. This principle, referred to as the substance of negotiations, states that the tax consequences of a transaction depend on how the parties negotiate as to the manner in which the transaction is to occur. In Court Holding Co., it is argued, this principle resulted in attribution of a sale of property by shareholders (following liquidation) to their corporation because the corporation had negotiated the sale. The principle and its extension to bootstrap stock acquisitions are explained:

In Court Holding, a corporation which had negotiated and agreed to the sale was treated by the court as having made the sale and then transferred the cash consideration to its shareholders, although the shareholders actually carried out the sales contract. Application of that principle to [the primary unconditional obligation context] means that the shareholder who had negotiated and agreed to the stock purchase should be treated as having made the purchase and then transferred the consideration received (the stock) to the corporation, although the corporation actually satisfied the purchase contract. Had the shareholder . . . actually made the purchase, he would have owed the seller money. Since under that construction the corporation would have satisfied a debt rather than an executory obligation, the facts are parallel to those in [a debt satisfaction case].

However much merit this argument may have as an attempt to provide a satisfactory jurisprudential explanation of the result in Sullivan, it fails to respond to the problems with the primary unconditional obligation test, particularly its wooden formality, its easy avoidability, the trap it presents for the unwary, and its taxation of a constructive dividend to an individual P who receives nothing except an artificially inflated basis in his stock in C.

Furthermore, the Court Holding Co. focus on the formal question of whether a sale was negotiated and therefore made by a corporation (before distribution) or by its shareholders (after distribution) led Congress to enact section 337 to moot the distinction in properly planned liquidation contexts, suggesting that Congress considered the theoretical underpinnings of Court Holding Co. less than overwhelming. While Congress never provided relief from the Court Holding Co. result in nonliquidation (continuing business) contexts, the change of ownership in a bootstrap stock acquisition is more analogous to the Court Holding Co. liquidation contexts addressed by section 337.

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126 324 U.S. 331 (1945).
127 Kingson, supra note 69, at 884.
129 Recent changes in § 311(d) which have the effect of undermining Court Holding Co. by recognizing gain to a corporation upon most distributions of appreciated property do not imply otherwise; the recent legislation is based on a wholly different theory. See supra text preceding and accompanying notes 37–38.
similar legislative response to the similarly formalistic primary unconditional obligation test would be appropriate.

A second source of possible constructive dividends in a bootstrap stock acquisition context is best illustrated by example. Assume P and S each own 50% of C’s stock. In January, P agrees to buy S’s 50% for its then fair market value of $10,000, the closing to occur after certain conditions are met. In October, the conditions are met, but 50% of C is only worth $7,000. P, unconditionally obligated to purchase S’s stock for $10,000, instead causes C to redeem S’s stock for $10,000. In this case, C has overpaid for the redeemed stock in taking over P’s obligation to pay $10,000 for $7,000 worth of C stock. P has been relieved of a net debt of $3,000 and C has distributed $3,000 in assets to P; P should be treated as receiving a $3,000 constructive dividend from C. Current administrative and judicial use of the primary unconditional obligation test to treat P as receiving a $10,000 constructive dividend in these circumstances has precluded development of this analysis in the law.

By way of summary, application of the primary unconditional obligation test treats P as receiving a constructive dividend when P in fact receives no distribution from C. This result, easily avoided by those with sophisticated tax counsel, presents a trap for unwary taxpayers and has produced continued litigation. Inasmuch as the test is based on an unsound rationale and leads to inappropriate tax consequences, it should be discarded.

Beneficial Ownership Test

Under the beneficial ownership test, a dividend distributed to S in connection with a bootstrap stock acquisition is taxed to the taxpayer—P or S—who had beneficial ownership of the stock when the dividend was declared. The cases applying this standard generally assume that a dividend in these circumstances must be treated for tax purposes as a dividend to either P or S. In some cases, of course, the dividend has

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130 See Steel Improvement & Forge Co. v. Commissioner, 314 F.2d 96, 98 (6th Cir. 1963) (when dividend is “established”); Casner v. Commissioner, 28 T.C.M. (CCH) 535, 541 (1969) (when dividend “declared”), rev’d on another theory, 450 F.2d 379 (5th Cir. 1971). For a summary of some earlier cases, see Hoffman v. Commissioner, 47 T.C. 218, 233 (1966), aff’d per curiam, 391 F.2d 930 (5th Cir. 1968).

been taxed to S in accordance with the formal aspects of the transaction.\textsuperscript{132}

The Service, however, has often succeeded in taxing the dividend to P.\textsuperscript{133} If the dividend is taxed to P, it is considered part of the price received by S for the sale of his C stock; that is, the transaction is treated for tax purposes as if implemented according to the P-Dividend Plan model.\textsuperscript{134} Assume P agrees to acquire C from S for $4,000, but C's net worth is $10,000 and P and S obviously contemplate a $6,000 dividend distribution to S. The tax consequences of the dividend distribution under this test will depend on who has beneficial ownership of C's stock when the dividend is declared. If P is treated as then possessing beneficial ownership of the stock, P will be treated as receiving a $6,000 dividend.\textsuperscript{135} An individual P will then receive a $10,000 basis in stock worth $4,000 at the cost of a tax on the $6,000 constructive (phantom) dividend. In this respect, this test produces as unsound a result as the primary unconditional obligation test.\textsuperscript{136}

The concept of beneficial ownership, however, is largely irrelevant in the posited situation. In the context of a sale of property, the beneficial ownership concept principally serves to determine the point in time at which the benefits and burdens associated with the property (especially, the risk of loss) shift from the seller to the buyer.\textsuperscript{137} For tax purposes, this shift represents an appropriate time to recognize the shift in ownership. Hence, the holding period with respect to property ends when beneficial ownership passes to the buyer.\textsuperscript{138} At that time, the seller's risk

\textsuperscript{132} \textit{E.g.}, Gilmore v. Commissioner, 25 T.C. 1321 (1956) (offer to purchase stock contemplated removal of certain liquid assets from corporation); Coffey v. Commissioner, 14 T.C. 1410 (1950) (unwanted asset distributed to seller as condition of sale where distribution authorized by directors prior to sale of stock). This was also the Tax Court's approach in Steel Improvement & Forge Co. v. Commissioner, 36 T.C. 265 (1961), \textit{reviewed} (1 dis.), \textit{rev'd}, 314 F.2d 96 (6th Cir. 1963).

\textsuperscript{133} \textit{See, e.g.}, Christensen v. Commissioner, 33 T.C. 500 (1959) (within one month of acquiring beneficial ownership, pursuant to stock purchase agreement, purchaser caused corporation to cash in life insurance policy and forward proceeds to seller who had retained legal title as security for payment of remaining purchase price); \textit{see also} Steel Improvement & Forge Co. v. Commissioner, 314 F.2d 96 (6th Cir. 1963) (court held that dividend not taxable as ordinary income to seller, although if seller had caused payment of smaller dividend, there would have been no purchase price adjustment, a fact which had caused the Tax Court to reach the opposite result), \textit{rev'd} 36 T.C. 265 (1961).

\textsuperscript{134} \textit{See supra} text accompanying notes 20–31.

\textsuperscript{135} \textit{See supra} note 133.

\textsuperscript{136} \textit{See supra} text accompanying notes 96–97.


\textsuperscript{138} \textit{See} 2 B. Bittker, \textit{Federal Taxation of Income, Estates and Gifts} \textsection{} 53.2 (1981) (relating to determination of holding period in situations involving options, sales agreements, and escrows); \textit{see also} 2 Lexington Ave. Corp. v. Com-
of loss or possibility of gain has ended; so, the tax law ends his investment holding period as well.

The bootstrap stock acquisition situation is not analogous to the holding period situation or other situations in which the beneficial ownership concept is useful. This is not to say that the courts have incorrectly answered the question as to which of $S$ and $P$ bore the risk of loss with respect to the $C$ stock at the time of a dividend distribution in connection with a bootstrap stock acquisition. Rather, the question is inappropriate when the dividend distribution is part of the bootstrap stock acquisition plan. The parties to a bootstrap stock acquisition usually bargain over the total amount $S$ will receive for his interest in $C$. If the agreement authorizes $S$ to receive part of this amount from $C$ by causing $C$ to distribute a dividend to $S$, $P$'s beneficial ownership of $C$ on the dividend declaration date is irrelevant because $P$ and $S$ anticipate that $C$'s value will be reduced by the amount of the distribution to $S$. It is inappropriate to treat $P$ as receiving a constructive dividend in such circumstances.

There are, however, two situations in which the beneficial ownership concept may play an important role in determining whether a seller or purchaser of stock is properly chargeable with a dividend. One situation involves a dividend declaration and distribution separated from the stock purchase by a considerable period of time; the other involves a dividend declaration and distribution made essentially contemporaneously with an unrelated stock purchase. Both situations differ considerably from the cases just discussed.

When a purported dividend distribution to $S$ is made a considerable period of time after the acquisition of stock by $P$ at a time when $P$ is otherwise fully in control of the $C$ stock in question, it may well be appropriate to treat $P$ as the recipient of the dividend on the ground that $P$ is the beneficial owner of the stock. For example, in Moore v. Commissioner,\textsuperscript{139} Mr. DeGuire agreed to purchase certain shares of stock from the taxpayer for $43,904 cash and $52,096 in installments payable with interest over three years. After the initial payment, the taxpayer-seller continued as owner of record of the shares, which were placed in escrow as security for the remainder of the purchase price. DeGuire was not personally liable for payment of the purchase price, and the agreement apparently contemplated that dividends paid by the corporation would be used to pay the remainder of the purchase price. A dividend was distributed to the seller as owner of record about a year

\textsuperscript{139} Moore v. Commissioner, 26 T.C. 816 (1956) (extensive discussion in case involving taxation of income from property prior to transfer of title, but after contractual allocation of expenses and crediting of income to purchaser).
later. The seller then sent the dividend check to DeGuire who forwarded it to the escrow holder for application against the notes; the escrow holder returned the check to the seller who endorsed it and deposited it in her account. The court noted that beneficial use of the shares of stock was "certainly" in DeGuire.\textsuperscript{140} The conclusion seems to have largely been based on DeGuire's substantial down payment, which would presumably have been lost if he had failed to pay the remainder of the purchaser price or the corporation went bankrupt, and the fact that DeGuire's share of corporate income over the three years might well have exceeded the remaining installment payments.\textsuperscript{141} On this basis, the court held the dividend not taxable to the taxpayer-seller, strongly implying that it was instead taxable to DeGuire.\textsuperscript{142}

Cases like Moore are distinguishable from the beneficial ownership cases discussed earlier because the actual dividend distribution in Moore was not clearly a part of an integrated bootstrap stock acquisition. In Moore, the seller played no role in determining the amount of, or in actually declaring, the dividend. In this respect, Moore resembles the situation found in Wall.\textsuperscript{143} Wall purchased stock and later had the corporation satisfy his indebtedness to the seller. The dividend treatment to Wall seems equally appropriate for the purchaser in Moore\textsuperscript{144} and similar cases.\textsuperscript{145} Nonetheless, it may be difficult at times to distin-

\textsuperscript{140} Id. at 993.

\textsuperscript{141} The seller retained the right to vote the stock for the directors, subject to certain restrictions, and, on other matters, also subject to various restrictions. These restrictions and the contractual language also indicated that the benefits and burdens of the stock had generally passed to the purchaser.

\textsuperscript{142} The Second Circuit reached this result as to Mr. DeGuire on somewhat different reasoning, apparently feeling that he had an option to buy the shares of stock until he actually applied the dividends to the shares' purchase. DeGuire v. Higgins, 159 F.2d 921 (2d Cir.), cert. denied, 331 U.S. 858 (1947). Judge Clark, however, concurred and accepted the rationale of the Seventh Circuit in Moore. Id. at 925.

\textsuperscript{143} Wall v. United States, 164 F.2d 462 (4th Cir. 1947).

\textsuperscript{144} The concomitant redemption of shares so acquired in Wall is obviously irrelevant since a redemption from a sole shareholder is always essentially equivalent to a dividend under § 301. United States v. Davis, 397 U.S. 301 (1970).

\textsuperscript{145} See Rev. Rul. 56–153, 1956–1 C.B. 166 (collecting cases involving dividends paid on shares of stock held by seller in trust to secure payment of purchase price). These cases have generally been analogous to Moore. See, e.g., Long v. United States, 66 Ct. Cl. 475 (1928) (dividends taxed to purchaser although applied against installment payments in 1917, 1918, and 1919 under 1912 stock purchase agreement; neither party seems to have been in control of corporation); Estate of Hobson v. Commissioner, 17 T.C. 854 (1951) (beneficial use of property in purchaser from late 1943 until 1945 despite seller's retention of record title; dividend taxed to purchaser). See also Walker v. Commissioner, 31 T.C.M. (CCH) 1109 (1972) (controlling voting trustee who exercised option to acquire 20% of stock of corporation immediately after board authorized dividend held taxable on dividend because his trusteeship and purchase option gave him com-
guish a Moore-type case from a case in which a dividend distribution to the seller results from an arrangement jointly worked out by the purchaser and seller. Difficulty in drawing a line at the margin between these cases, however, does not justify ignoring the important substantive distinction between the two.\textsuperscript{146}

Perhaps more problematical than the Moore-type situation is that involving a dividend which is essentially contemporaneous with a truly unrelated stock purchase. The potential difficulty arises in establishing the absence of a relationship between the stock purchase and the dividend, establishing that the dividend is not simply part of the financing for a bootstrap stock acquisition. The regulations, by considering the dividend for tax purposes to be the income of whichever party is entitled to the dividend,\textsuperscript{147} are not much help. Such a standard applies with little difficulty to dividends distributed with respect to publicly traded stock, as to which dividend entitlement depends on beneficial ownership as of a designated record date over which a stock seller and purchaser have no control. The absence of seller-purchaser planning for a dividend distribution is less easily shown, however, in the case of a closely held corporation.

This problem is illustrated by Walker v. Commissioner,\textsuperscript{148} where Mr. Fait acquired all of a corporation's stock, and immediately thereafter sold 70\% of the stock at his cost (including 20\% to Walker) and gave the remaining 30\% to his children. Fait required each transferee to give him an option to repurchase the stock at a formula book value, and to execute an agreement designating him as voting trustee with respect to the stock. The following year the corporation's board of directors authorized a pro rata distribution (as of a prior record date); immediately after the board meeting, Fait exercised his option to repurchase Walker's stock.

At issue in Walker was the tax treatment of the dividend paid to Walker. The Tax Court treated the dividend distribution as part of the sales price of Walker's shares and as a taxable dividend to Fait. The Ninth Circuit reversed, noting that Walker was beneficial owner of the stock on the date of the dividend declaration, and held Walker taxable

\textsuperscript{146} Certainty and planning can be facilitated by providing a statutory rule that treats any distribution within, for example, six months of a bootstrap stock acquisition as made in connection with the bootstrap stock acquisition. See infra text accompanying notes 229--54.

\textsuperscript{147} Reg. § 1.61--9(c).

\textsuperscript{148} 31 T.C.M. (CCH) 1109 (1972), rev'd, 544 F.2d 419 (9th Cir. 1976).
on the dividend.140 The court noted, correctly, that control over a corporation is not the equivalent of beneficial ownership of its stock.150 The court’s wooden emphasis on who had beneficial ownership of the stock, however, caused it to overlook the significant factors in the case.

Walker is distinguishable from other bootstrap cases because shareholders who were not parties to Fait’s repurchase of Walker’s stock participated in the dividend distribution on a pro rata basis.161 In this respect, Walker resembles the situation present when a public corporation distributes a dividend, and some shareholders contemporaneously sell their shares. Walker, however, differs from situations involving dividend distributions with respect to publicly traded stock precisely because of Fait’s control over the corporation. This control argues for bootstrap stock acquisition treatment on Walker’s facts and against the Ninth Circuit’s use of the beneficial ownership test to assign dividend tax treatment. However, a uniform scheme for taxing bootstrap stock acquisitions must consider whether someone in Fait’s position should be permitted to establish that the dividend distribution was unrelated to his stock purchase.162

Economic Substance Test

The economic substance test has not been widely applied and cannot be understood except by reference to its origin. The Fifth Circuit seems to have backed into the test in an effort to treat either the purchaser or the seller as a dividend recipient in the unusual situation found in Casner v. Commissioner.163 The Casner decision depended, strangely enough, on an earlier decision, Waterman Steamship Corp. v. Commissioner,164 where the Fifth Circuit found no dividend. Hence, an examination of the economic substance test must begin with Waterman Steamship.

Waterman Steamship can best be understood by a greatly oversimplified review of its facts. The buyer and the seller in Waterman Steamship engaged in a series of transactions designed to allow the seller to convert most of the proceeds of the sale of Pan-Atlantic, the corporation in question, into an intercompany dividend which could then be

140 544 F.2d at 422.
150 The court accepted the Commissioner's argument that the Tax Court theory implied that Fait was beneficial owner of all of the corporation's stock. Id.
162 See infra note 241.
163 450 F.2d 379 (5th Cir. 1971). The Tax Court had applied the beneficial ownership test. 28 T.C.M. (CCH) 535 (1969).
eliminated from the seller's income under the consolidated return regulations then in force, although there was apparently no intention to reduce Pan-Atlantic's net assets.\textsuperscript{155} Pan-Atlantic first declared and paid a dividend to the seller in the form of its note. The seller next approved the sale of Pan-Atlantic according to previously negotiated, but not finalized (in writing) terms, and the closing agreement for the sale was executed. The buyer and its controlling shareholder immediately loaned funds to Pan-Atlantic which then used the funds to pay off the note originally distributed as a dividend. However, since these steps all occurred in approximately 90 minutes, the Fifth Circuit had no trouble holding the dividend to be part of the purchase price received by the seller for the Pan-Atlantic stock, with Pan-Atlantic simply serving as a conduit for the buyer's funds to the extent of the dividend.

In \textit{Waterman Steamship}, the court's finding that the economic substance of the transactions was wholly a sale of the Pan-Atlantic stock was facilitated by the fact that the court apparently assumed Pan-Atlantic's net worth was not altered by the transactions when they were viewed in the aggregate.\textsuperscript{156} \textit{Casner}, however, involved a clear reduction in the net worth of the corporation as a result of the dividend distributions. In \textit{Casner}, dividends declared prior to the signing of binding stock purchase agreements, but pursuant to an understanding reached in negotiating those agreements, were paid on a pro rata basis to all the original shareholders, including the sellers, buying-continuing shareholders, and nonbuying-continuing shareholders. The distributions, as intended, reduced the value of the corporation, making it easier for the buying-continuing shareholders and new buyers to purchase the percentage interests intended.

The \textit{Casner} court, looking first at the selling shareholders, noted that "the true substance, purpose, and effect of the multistep plan . . . was that the selling stockholders would sell all of their stock."\textsuperscript{157} Hence, relying on \textit{Waterman Steamship}, the court found the economic substance of the dividends paid to the sellers to be part of the purchase price for their stock, entitling them to capital gain treatment.\textsuperscript{158} However, because the dividends represented cash distributions, the court assumed that the dividends had to be taxed to someone, so the court treated the buying-

\textsuperscript{155} Under current law, the dividend distribution would have been unnecessary; the seller's basis in the Pan-Atlantic stock would have been increased by the amount of Pan-Atlantic's earnings and profits. \textit{See} Reg. \textsection 1.1502-32.

\textsuperscript{156} This implies that the loans by the buyer and its controlling shareholders to Pan-Atlantic were equity, but the court did not explore this question.

\textsuperscript{157} 450 F.2d at 397.

\textsuperscript{158} This conclusion is in accord with the author's overall conclusions in this article.
continuing shareholders as receiving taxable dividends because "they received the economic benefit from the cash distributions." 160

The economic benefit referred to in Casner supposedly derived from the reduction in corporate book value resulting from the dividend distribution. The court did not explain why this was of economic benefit to the buyer. 160 The Casner court seems, however, to have fallen into an error regarding the nature of a dividend akin to those that seemed in part to underlie the Sullivan court's ready espousal of the primary unconditional obligation test. 161 That is, the court overlooked the fact that a dividend requires not only a distribution out of corporate solution, but also that the distribution be made to the shareholder sought to be taxed. The distribution in Casner, clearly made to the sellers, did not have the necessary characteristics of a dividend taxable to the purchasers. 162

The mere fact that S receives a dividend distribution as an integral part of a bootstrap stock acquisition plan seems to offer no particular justification for taxing P with a constructive dividend unless an analogy is to be drawn from section 305: The dividend distribution to S enables P to increase his proportionate interest in C at no additional cost and, therefore, P arguably should be treated as receiving a constructive dividend. (Perhaps this is the rationale the Casner court alluded to in referring to the benefit to P from the reduction in C's book value.) Section 305, however, only taxes P's analogue (the shareholder whose proportionate interest in corporate earnings and assets increases) with a constructive dividend to the extent S's analogue (the shareholder who receives a distribution of cash or property) has in fact received a taxable dividend distribution. Section 305 apparently calls for this result on the theory that P's analogue, in the section 305 context, also receive a distribution of a taxable dividend which he then reinvests (in additional stock in C).

The section 305 context, however, is not akin to a bootstrap stock

160 450 F.2d at 398–99. It is unclear whether the court would have extended such constructive dividend treatment to the new buyers as well; the new buyers were not before the court. Had the court treated the dividend distributed to the sellers as really made in redemption of the sellers' stock, perhaps it would not have missed itself. Redemption treatment of the dividends distributed to the continuing shareholders who neither bought nor sold stock might also have been appropriate, subject to the operation of § 302. Cf. Coven, The Relevance of Fresh Investment to the Characterization of Corporate Distributions and Adjustments, 38 Tax L. Rev. 419 (1983).

160 This is perhaps why Casner has received considerable comment and criticism. See Jassy, supra note 69, at 1473–75; Kingson, supra note 69, at 892; Schaffer & Gordon, Taxing Intercorporate Dividends Received As Part of the Sale of a Subsidiary, 30 Tax L. 727, 746–58 (1977).

161 Supra text accompanying notes 93–95.

162 Whether the seller should be treated as receiving a dividend is discussed in the text accompanying notes 211–28.
acquisition for two reasons. First, in a section 305 context both P's analogue and S's analogue continue to be shareholders of C; in a bootstrap stock acquisition case, however, S's interest in C is usually terminated. Second, in a section 305 context, both P's analogue and S's analogue are treated as dividend recipients; only one of P or S is treated as a dividend recipient in any given bootstrap stock acquisition. The continuing relationship between the shareholders and C in section 305 cases that results in continued distributions to S's analogue and increases in the proportionate interest of P's analogue in C's earnings and assets is therefore not a proper analogy for the sale of S's interest that occurs in a bootstrap stock acquisition. Indeed, even section 305 is apparently not intended to apply to isolated redemptions.\footnote{S. Rep. No. 552, 91st Cong., 1st Sess. 153–54, reprinted in 1969–3 C.B. 423, 521. See also Reg. § 1.305–3(e) Exs. 10, 11, § 1.305–3(b)(3).} Even assuming that its application in the context of periodic redemption plans is well founded, there seems to be no justification for extending the principles of section 305 to the context of a one-time distribution in dividend form as part of a bootstrap acquisition.

Two other aspects of the economic substance test are disturbing. First, treating an individual P as the recipient of a constructive dividend under the Casner rationale leads to the same unsound basis result for P as does application of the primary unconditional obligation test or the beneficial ownership test; that is, an individual P then takes the stock of C with a basis that exceeds its fair market value by the amount of the constructive (phantom) dividend.\footnote{See supra note 136 and accompanying text.} Second, Casner's rationale seems to lead ineluctably to an automatic constructive dividend rule for P whenever a purported dividend distribution is made to S in connection with a bootstrap stock acquisition. Such a result would obviously impose a tax impediment to bootstrap stock acquisitions; this alone would probably counsel against use of the economic substance test.

Perhaps for these reasons, the Casner decision and the economic substance test have met with little acceptance. The Service has announced it will not follow Casner in cases involving an individual S, but will instead honor the form of the distribution and tax the dividend to the individual S.\footnote{Rev. Rul. 75–493, 1975–2 C.B. 109.} With respect to a corporate S, however, the Service view of Casner's status is unclear.\footnote{The Service has unofficially followed Revenue Ruling 75–493 in the corporate S situation. See, e.g., TAM 8118004 (Dec. 31, 1980). The Service, however, has not taken an officially published position in this context.} Furthermore, the extent to which taxpayers can use the holding to their own advantage is also unclear. The Fifth Circuit itself distinguished Casner in TSN Liquidating Corp. v. United States,\footnote{624 F.2d 1328 (5th Cir. 1980).} a case in which a corporate seller received a distribu-
tion of certain marketable stocks as a dividend because the buyer did not want to purchase the stocks. The buyer in *TSN* infused additional capital, in the form of municipal bonds, into the corporation immediately after the sale, thus making the earlier distribution look as if it had been part of the purchase price for the stock funneled through the corporation as a conduit. The presence of business reasons for the change in the nature of the corporate assets, however, led the court to reject the *Casner-Waterman Steamship* analysis and allow the seller the dividends received deduction with respect to the dividend in question. This result, however, depending on a subtle balancing of motives and purported economic substance, leaves the current law in this area in a state of great uncertainty.

**Appropriate Model for Taxing Bootstrap Stock Acquisitions**

The first part of this article spells out that different tax consequences that result from choosing to carry out a bootstrap stock acquisition in each of the three different forms permitted under current law. The second part considered the extensive case law that has resulted from attempts by the Service and, at times, taxpayers to treat bootstrap stock acquisitions carried out in one form as if carried out in another form for federal income tax purposes, and concluded that the case law doctrines by and large lead to inappropriate results. Nevertheless, the extensive litigation and confusion elaborated upon in the second part of the article is a largely predictable byproduct of the availability to informed taxpayers of the three alternatives for structuring a bootstrap stock acquisition. This part of the article considers whether the tax law should permit taxpayers choices regarding the tax treatment of bootstrap stock acquisitions; if so, how the choice should be permitted; and, if not, how acquisitions should be taxed given the current system of corporation-shareholder taxation. The analysis concludes that the S-Redemption Plan represents the appropriate model for taxing all bootstrap stock acquisitions.

Rejection of the case law doctrines heretofore discussed does not necessarily imply that the law should permit parties structuring a bootstrap stock acquisition to choose their tax consequences by simply choosing one of the three basic forms for implementing the transaction. Such an approach (hereinafter called “the pure form approach”) is only one of five possibilities that could be used to determine the tax consequences of bootstrap stock acquisitions given the current corporate-shareholder tax structure. Instead of the present method, the parties could choose the tax consequences of a transaction by filing an election with the Service specifying the tax characterization chosen, the election being
independent of the form of the transaction.\textsuperscript{168} (This approach is hereinafter called the "election approach.") Finally, all bootstrap stock acquisitions could be taxed in the same way regardless of their form, in accordance with the P-Dividend Plan model (hereinafter called the "P-Dividend approach"), the S-Redemption Plan model (hereinafter called the "S-Redemption approach"), or the S-Dividend Plan model (hereinafter called the "S-Dividend approach"). (These approaches are hereinafter collectively referred to as the "no-choice approaches.") Any of these approaches would require further definition for actual implementation. Each approach will be considered in light of both institutional concerns (principally, legal complexity, administrative efficiency, and impact on general taxpayer compliance) and substantive tax concerns. To some extent these concerns overlap or affect each other, and some of the same issues arise under different approaches. For example, the element of taxpayer choice or lack of choice is an important issue throughout. In any event, a systematic examination of the five approaches provides useful insights.

**Pure Form Approach**

The pure form approach would tax a bootstrap stock acquisition and related distributions, in the form of dividends or redemptions, according to the form the transactions take. Thus, under the pure form approach, bootstrap stock acquisitions implemented under an S-Dividend Plan would receive the tax treatment attendant upon the S-Dividend Plan form.\textsuperscript{169} Similarly, acquisitions implemented under an S-Redemption Plan or a P-Dividend Plan would receive the tax treatment associated with the S-Redemption Plan or the P-Dividend Plan form, respectively.\textsuperscript{170} As a practical matter, however, the parties would rarely choose to implement a bootstrap stock acquisition under a P-Dividend Plan because the S-Redemption Plan or the S-Dividend Plan would almost always be preferable taxwise.\textsuperscript{171} Accordingly, substantive discussion of the pure form approach will focus on the choice between S-Redemption Plan tax treatment and S-Dividend Plan tax treatment.

The pure form approach resembles the election approach in that it

\textsuperscript{168} Another variation on the election approach would be to have the parties elect their tax treatment in their contractual documents. This is really a hybrid of the pure form approach and the election approach, and probably offers no particular advantages. *Cf. ALI, supra* note 95, at 50 (rejecting such an approach to another problem).

\textsuperscript{169} See supra text accompanying notes 4–10. This assumes that the pure form approach does not incorporate the current primary unconditional obligation test.

\textsuperscript{170} See supra text accompanying notes 11–19 (S-Redemption Plan model) and 20–31 (P-Dividend Plan model).

\textsuperscript{171} See supra text accompanying notes 32–34.
allows the parties to choose their tax consequences. The two approaches
differ in how the choice is made. Taking both the choice and method
of choice aspects of the pure form approach into account, institutional
concerns seem to argue in favor of the pure form approach, particularly
if it is made explicit by statute. The pure form approach would argu-
ably provide a clear standard for determining the tax consequences of a
bootstrap stock acquisition. This clear standard would, in turn, arguably
facilitate the planning of such transactions and reduce both planning
costs and disputes over the tax consequences of bootstrap stock acquisi-
tions. Unfortunately, however, the historical development of this area
of the law raises serious doubts as to the likelihood that any of these
benefits would follow from the pure form approach.

The distinctions inherent in a pure form approach would probably
instead produce the opposite effects, all of which are evident under cur-
rent law: legal complexity, continued high costs for compliance and
administration, and, possibly, a negative impact on taxpayer compliance
in general. These effects would be largely due to the pure form ap-
proach's inclusion of three possible tax characterizations for what are
essentially equivalent bootstrap stock acquisitions. This would obviously
entail considerable legal complexity because the legal rules would have
to clearly indicate the transactional forms that would lead to the chosen
tax consequences in addition to spelling out the three alternative sets
of tax consequences. Furthermore, this emphasis on formal distinctions
would tend to generate litigation over the tax consequences of transac-
tions inadvertently carried out in either an unintended form or an am-
biguous form, thus adding further complexities to the case law. The
legal complexity that would be likely to result from the pure form ap-
proach is amply demonstrated by the discussion of current law in the
first two parts of this article.

Nonetheless, while legal complexity in the tax law is surely to be dis-
favored in general inasmuch as it prevents the average interested citizen
from understanding the tax law,\(^{172}\) some situations may justify this com-

\(^{172}\) Recent proposals for fundamental tax simplification have focused consi-
derable attention on the complexity of the tax law. See U.S. DEPARTMENT OF TREASURY, TAX
REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH—GENERAL EXPLANATION OF THE TREASURY DEPARTMENT PROPOSALS 3–4, 15–16
(1984); American Bar Association, Section of Taxation, Committee on Basic Tax
Structure and Simplification, Bradley-Gephardt and Kemp-Kasten Bills, 38 TAX
LAW. 381 (1985). However, these legislative proposals for tax simplification
usually aim most of their ammunition at the perceived unfairness and economic
distortions resulting from the tax system, and are therefore unlikely to achieve the
degree of simplification sought. See Lang, Simplicity and Fairness in the Income
Tax: The Case of Fringe Benefits (Maine Public Broadcasting Network; Oct. 24,
1984) (noting that a trade-off is often necessary between fairness and simplicity);
plexity. First, some business activities are inherently complex and proper taxation of those activities may require similarly complex tax statutes—to expect easily understood tax laws with respect to complex financial activities is probably unrealistic. This may, for example, partially explain the complexity of subchapter L, dealing with the taxation of insurance companies. As the average interested citizen cannot be expected to understand how the insurance business operates, perhaps it is unreasonable to expect such an average citizen to understand how insurance companies are taxed. In any event, the complexity of the insurance business seems to require a similarly complex system for taxing insurance companies.

A second instance in which legal complexity is at least arguably justifiable arises when the legal complexity is a byproduct of efforts to ease taxpayer compliance or achieve other important goals. For example, the incorporation of the old standard deduction into the section 1 rate schedules required the introduction into the Code of the zero bracket amount concept, the complex rules of section 63(b) through (g), and numerous conforming amendments. Although these changes added substantial complexity to the Code, they have made taxpayer computation of the income tax much easier for nonitemizers by eliminating a step in the computation (subtracting the old standard deduction from adjusted gross income in computing taxable income). This has allowed simplification of tax forms and has presumably reduced the number of arithmetic errors on income tax returns, thus aiding administration of the tax laws. Whether these benefits offset the disadvantages of having a statute like section 63 and the related conforming amendments is a matter of judgment, but the benefits are nonetheless substantial.

The complexity arising out of the pure form approach to bootstrap stock acquisitions cannot be justified on either of the above grounds. There is nothing particularly complex about a bootstrap stock acquisition that requires giving taxpayers a choice as to the acquisition's tax treatment, whether through the pure form approach or the election approach. Nor would there appear to be substantial administrative or compliance benefits that would flow from the pure form approach. Indeed, the opposite seems to be the case: The pure form approach would continue to place a premium on tax planning for bootstrap stock acqui-

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sitions by continuing the tax distinctions currently relevant in taxing these acquisitions, such as those between dividends and redemptions, those between dividends to sellers and dividends to purchasers, and those affecting basis and earnings and profits calculations. Furthermore, distinctions would continue to be tied to the form in which the transaction is implemented. Planning transactions in these circumstances would require sophisticated decisions by taxpayers and sophisticated drafting by lawyers, both of which would tend to increase compliance costs. Some taxpayers, particularly those involved in buying or selling small businesses, lack the sophistication and counsel to make and carry out decisions of this sort on a reasonable basis and would be likely to fall into tax traps as a result.\footnote{175} Emphasis on formal distinctions would also enable some taxpayers to seek cleverly drafted documents the ambiguity of which would allow the purchaser and the seller reasonably to report a transaction in inconsistent ways, at the government's expense.\footnote{176} Sophisticated taxpayers would not only spend much of their own time planning bootstrap transactions, but would also seek out the advice of tax lawyers, accountants, appraisers, and others to properly plan their transactions.\footnote{177} While these potential costs are difficult to estimate, they would probably be substantial. The vast case law and literature on the subject of planning and taxing bootstrap stock acquisitions is probably just the visible tip of the iceberg under the largely formalistic current law.\footnote{178}

The elective aspect of the pure form approach might also have a more diffuse impact on overall taxpayer compliance. Our tax system is said to depend in large part on so-called voluntary taxpayer compliance.\footnote{179} However, the perception that high income taxpayers and

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\footnote{175} For this problem under the Sullivan doctrine, see the text accompanying notes 109–20.

\footnote{176} See infra notes 188–89 and accompanying text.

\footnote{177} See generally Turnier, Designing an Efficient Value Added Tax, 39 TAX L. REV. 435 (1984), in which Professor Turnier's field research on the British VAT disclosed four criteria for designing an efficient tax—minimizing (1) the number of taxpayers, (2) difficult determinations and areas of potential dispute (borders between items taxed at different rates), (3) additional record keeping and compliance and reporting paperwork, and (4) the need to resort to professionals. Although Professor Turnier's study focused on a VAT, he believes (and the author concurs) that his conclusions are applicable to designing any efficient tax. The pure form approach to taxing bootstrap acquisitions satisfies none of Professor Turnier's criteria.

\footnote{178} Data on the costs of administering and complying with specific features of a tax in the context of specific transactions, such as bootstrap stock acquisitions, are generally not available. Cf. Turnier, supra note 177, at 436–37 (referring to existing studies, none of which relates to bootstrap stock acquisitions). Nor is it clear how reliable data on such a subject could be gathered.

\footnote{179} In fact, compliance rates seem to be highest where income reporting and tax collection are substantially involuntary. See Henry, Noncompliance with U.S.
businesses, particularly corporations, can avoid paying their fair share of income taxes is apparently reducing the respect of other taxpayers for the tax system. Increasingly, the argument goes, low and middle income taxpayers simply fail to report part or all of their income because they believe high income taxpayers have legal means to avoid paying taxes (loopholes). Thus, the notion that paying taxes is voluntary in the sense of optional—you pay taxes if you want to, but otherwise you simply plan to avoid taxes—has seriously undermined public confidence in, and attendant compliance with, the tax laws. Allowing the parties to a bootstrap stock acquisition to structure the acquisition to their collective tax advantage would only serve to reinforce this growing taxpayer view that businessmen and high income taxpayers, such as shareholders, only pay taxes to the extent they are so inclined. Accordingly, the pure form approach would probably tend to undermine taxpayer confidence in the tax system and contribute—albeit probably to a limited extent and in combination with similar approaches to taxing other kinds of transactions—to the continuing erosion of the system of voluntary compliance. This factor, possibly insignificant on its own, reinforces the conclusion that the pure form approach would be undesirable from an institutional point of view.

There is one sense in which the pure form approach would arguably reflect a substantive analogue: In one respect, whether a distribution constitutes a dividend is only a matter of form. As noted above, a dividend does not increase a shareholder's net worth; it merely transfers part of the shareholder's net worth from one pocket to another pocket, from inside the corporate solution to outside the corporate solution. In

_Tax Law—Evidence on Size, Growth, and Composition, 37 Tax L. 1, 4 (1983). Henry's conclusion is buttressed by many of the papers included in_Income Tax Compliance: A Report of the ABA Section of Taxation Invitational Conference on Income Tax Compliance (1983) [hereinafter cited as Income Tax Compliance]. Perhaps it is better to view the federal income tax system as "really voluntary only in the sense that it initially trusts the taxpayer rather than the government to calculate and remit the tax due." Doernberg, _The Case Against Withholding_, 61 Texas L. Rev. 595, 595 (1982).

180 See generally Henry, _Noncompliance with U.S. Tax Law—Evidence on Size, Growth and Composition, 37 Tax L. 1 (1983); Income Tax Compliance, supra note 179._

181 The atmosphere is indicated by the publication of articles such as Hoeflitch, _Of Reason, Gamesmanship and Taxes: A Jurisprudential and Games Theoretical Approach to the Problem of Voluntary Compliance, 2 Am. J. Tax Pol'y_ 9 (1983) (suggesting many perceive tax laws as rules of a game which one tries to win, even if winning requires cheating, rather than legal-normative rules giving rise to obligations that should be obeyed); Cooper, _A Voluntary Tax? New Perspectives on Sophisticated Estate Tax Avoidance, 77 Colum. L. Rev._ 161 (1977).

182 Supra text accompanying notes 89–95. Cf. Kingson, _supra_ note 69, who argues that this "form" characteristic of dividends supports allowing the parties to choose how their bootstrap stock acquisition should be taxed.
this sense, a dividend simply reflects a corporate decision to distribute property and trigger taxation of its shareholders, as opposed to a decision to retain earnings and not trigger a taxable event for the shareholders. Nonetheless, whether to have a taxable event is not the choice in characterizing a bootstrap stock acquisition for tax purposes; all bootstrap stock acquisitions constitute taxable events to the seller. Hence, the fact that a dividend is a formal incident of a taxable event for shareholders cannot support the pure form approach to taxing bootstrap stock acquisitions.

In some ways, of course, the choice between a dividend and a redemption is often little more than a matter of form for corporate law purposes. Nevertheless, outside the bootstrap stock acquisition area, transactional form does not determine whether a distribution is to be taxed as a dividend or as a redemption. A series of detailed Code provisions recharacterize many redemptions (and some other analogous dispositions of stock) as dividends on the theory that these redemptions do not effect a significant change in relative shareholder ownership interests, and are substantially equivalent to dividend distributions. The fact that the particular distribution takes the form of a redemption under corporate law is irrelevant because the economic substance of the distribution more closely resembles what the tax law considers a dividend—a distribution of the profits of a going concern to continuing shareholders.

Given this rejection of form as determinative or even relevant in characterizing redemptions as either redemptions or dividends for tax purposes, the pure form approach to bootstrap stock acquisitions would be inappropriate in drawing a dividend-redemption line solely on the basis of form. Allowing S a choice of dividend or redemption treatment would mean that economically equivalent transactions would be taxed differently. Some distributions to S in connection with bootstrap stock acquisitions would result in capital gain to S; others would be treated as dividends. A corporate S would generally plan to receive a dividend in order to take advantage of the dividends received deduction under section 243, while a noncorporate S would generally have stock redeemed to obtain capital gain treatment. (This assumes that P would be indifferent as to the form in which S received the distribution.) These choices would also have peripheral effects that have been noted in the first part of this article. There is no substantive reason, however, for allowing

such a choice in tax treatment. S, in both cases, is simply getting part of the purchase price for his stock from C, rather than from P, pursuant to a plan to completely terminate his interest in C. Allowing S to choose between dividend and redemption treatment seems unjustifiable, particularly if one model represents the appropriate tax treatment of bootstrap stock acquisitions regardless of their form.

**Election Approach**

The election approach would offer advantages and disadvantages similar to those that would accompany the pure form approach because, like the pure form approach, the election approach would allow the parties to choose the tax characterization of their bootstrap stock acquisition.\(^{184}\) The institutional impact of the election approach would, however, differ in certain ways. First, any tax election entails increased legal complexity. When an election must be filed with the Service, the law must provide standards as to who is eligible to file, what information must be included in the filing, how the information should be included, and where and when the taxpayer must file.\(^{185}\) Litigation over these issues often follows.\(^{186}\) All of this also entails increased administrative and compliance costs for taxpayers and the Service. When compared with the pure form approach, however, these increased costs might well be more than offset by a reduction in costs otherwise associated with planning and drafting the formal documents needed to obtain the desired tax consequences, as well as by the absence of tax disputes that might otherwise arise as to the characterization of the bootstrap stock acquisition.\(^{187}\)

In addition, the election approach could preclude the possibility of different parties to the acquisition taking different tax positions as to its tax characterization\(^{188}\) by requiring all the parties to join in the election.

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\(^{184}\) *Supra* text accompanying notes 171–81.

\(^{185}\) See, e.g., Reg. § 1.333–3 (election procedure under § 333); Temp. Reg. § 1.338–1T, T.D. 7855, 1982–2 C.B. 79 (elections under § 338(g)).

\(^{186}\) See, e.g., Posey v. United States, 449 F.2d 228 (5th Cir. 1971) (extensive discussion of these issues under § 333).

\(^{187}\) For a similar problem under the purely formal primary unconditional obligation test, see State Pipe & Nipple Corp. v. Commissioner, 46 T.C.M. (CCH) 415 (1983); Montpetit v. Commissioner, 45 T.C.M. 304 (1982); Revzin v. Commissioner, 36 T.C.M. (CCH) 289 (1977). In this connection, it is noteworthy that such planning and administrative efficiency advantages of an election approach have been actively espoused in the corporate reorganizations area (taxable versus tax-free) with little attention being given to the related institutional disadvantages of such an approach. See ALI, *supra* note 95, at 34–50; Leduc, *Current Proposals to Restructure the Taxation of Corporate Acquisitions and Dispositions: Substance and Process*, 22 SAN DIEGO L. REV. 17, 55 (1985).

\(^{188}\) See *supra* note 76 (cases where purchaser and seller reported transaction
This would probably further complicate the election procedure.\textsuperscript{180} In any event, these benefits of the election approach would be equally available under the no-choice approaches without the election approach's concomitant costs and complications.

One further complication of the election results from the fact that some taxpayers would probably fail to file a timely required election. Hence, an election approach must include a fallback position providing for the taxation of bootstrap stock acquisitions as to which no timely election is filed.\textsuperscript{180} These acquisitions would presumably be taxed according to one of the other approaches—the pure form approach, the S-Redemption approach, the P-Dividend approach, or the S-Dividend approach. As a result, in at least one sense, the election approach would be inherently more complex than any other approach. Indeed, because the election approach requires selection of another approach as a norm, it must inevitably present more institutional disadvantages than any other approach.

While the pure form approach would cause the tax characterization of a bootstrap stock acquisition to be determined by its corporate law form, adoption of the election approach would represent an acknowledgment that the corporate law form of the transaction is irrelevant. The irrelevance of the form of the transaction would arguably be an advantage to the election approach. A bootstrap stock acquisition could be planned without concern about its tax consequences because the parties could later choose their tax consequences in making the required election. This might prove particularly valuable to the parties where nontax considerations necessitate an acquisition in one form or another. For example, state corporate law restrictions on the payment of dividends might require that a distribution to $S$ be made in the form of a redemption. The election approach, unlike the pure form approach, would

\textsuperscript{180} Cf. Temp. Reg. § 18.1362–2, T.D. 7872, 1983–1 C.B. 193 (spelling out requirement that all shareholders consent to an $S$ corporation election under § 1362); Reg. § 1.333–2 (qualified electing shareholder requirement for § 333 election, which requires like elections by holders of at least 80% of total combined voting power, subject to exceptions).

\textsuperscript{190} See ALI, supra note 95, at 42–43, noting that an explicitly elective procedure for taxing corporate reorganizations would require a norm roughly consistent with existing law for cases in which there is no effective election. No consideration is given to how this might affect the viability of the electivity proposal, although the report says the norm should be as consistent "as possible with the likely expectations of those who are most apt to neglect to make a specific election."
allow a corporate S having stock redeemed to elect to treat the redemption proceeds as a dividend for tax purposes; the dividend would presumably qualify for the section 243 dividends received deduction. Similarly, if a dividend distribution were made to an individual S to avoid corporate law complications associated with a redemption, the election approach would enable him to elect to treat the dividend distribution as a redemption that would qualify for capital gain treatment.\textsuperscript{101}

The election approach's tacit acknowledgment that the form of a bootstrap stock acquisition is irrelevant, however, also highlights the economic equivalence of all forms of carrying out a bootstrap stock acquisition. In this light, allowing the parties an express election as to the tax consequences of the acquisition seems inappropriate. Furthermore, because the choice of tax consequences under the election approach would not even be tied to the form of the transaction, the election approach would probably be viewed as allowing affected shareholders an unfair option as to the ultimate amount of their income taxes. Hence, the election approach would be likely to undermine general taxpayer attitudes and compliance more than would the pure form approach.

\textbf{No Choice Approaches}

Adoption of any one of the no-choice approaches would reflect a legislative decision to reduce or eliminate tax planning as an important consideration in planning and implementing a bootstrap stock acquisition. A legislative effort to eliminate the parties' power to choose the most advantageous tax characterization for a bootstrap stock acquisition (S-Redemption, S-Dividend, or P-Redemption Plan) would not, however, preclude tax considerations from playing a role in bootstrap stock acquisitions. The tax characterization of the acquisition would undoubtedly affect the willingness of potential parties to proceed with the transaction, and the terms on which they would be willing to proceed. For example, statutory adoption of the P-Dividend approach, by treating all purchasers in bootstrap stock acquisitions as dividend recipients, would tend to (1) reduce the prices individual purchasers would be willing to pay in making bootstrap stock acquisitions, and (2) make some otherwise potential purchasers unwilling to proceed with bootstrap stock acquisitions that would be economically sound absent that dividend treatment. Thus, parties considering a bootstrap stock acquisition under such a statute would obviously weigh its tax

\textsuperscript{101} In this situation the statute would have to provide a method for determining the number of shares of stock redeemed, S's basis in such stock, and the resulting charge to C's earnings and profits. See infra text accompanying notes 229–54.
consequences, perhaps in consultation with tax counsel or accountants.

Nonetheless, the tax planning and the consultation with tax professionals necessary to fully inform taxpayers in the context of a no-choice statute would be less cumbersome, less time-consuming, and less complex than the tax planning and consultation necessary under the pure form approach or the election approach. The latter approaches would both require evaluation and comparison of three fundamentally different tax characterizations for the bootstrap transaction, as well as negotiations between the parties in light of the analysis. The pure form approach would then demand that the transaction be implemented with great attention to formalities—presumably, the controlling technical niceties of both contract law and corporation law—while the election approach would require the parties to adhere to a similarly technical regulatory election procedure. As noted above, the formalities in the one case and the election procedure in the other case both inevitably produce further complexity and administrative problems. Under a no-choice approach, by contrast, the purchaser and the seller would evaluate the transaction’s economics in light of the clearly spelled out tax treatment provided by statute and would then negotiate as to price.

The institutional advantages and disadvantages of a no-choice approach depend, however, on the statute effectively precluding a purchaser and a seller from structuring a bootstrap stock acquisition in a way which would sidestep the statutory tax treatment in order to obtain the tax treatment that would follow under one of the rejected alternatives. If, with sophisticated planning, taxpayers could evade the statutory tax treatment, a no-choice approach would offer much more limited advantages over the pure form approach or the election approach. In particular, one school of tax thinking holds that statutory attempts to limit planning flexibility in the corporate area are doomed to failure because of the inventiveness of tax lawyers. According to this line of argument, for example, a corporate seller in a bootstrap stock acquisition would be able to obtain S-Dividend Plan treatment despite a statute

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192 Supra text accompanying notes 175–81 (formalities) and 184–89 (election procedure).

193 This view largely underlies proposals to allow corporate level electivity between gain recognition/basis step-up treatment and nonrecognition/basis carry-over treatment for corporate acquisitions. See Staff of Senate Committee on Finance, The Reform and Simplification of the Income Taxation of Corporations, S. Prt. No. 95, 98th Cong., 1st Sess. (1983); Reform of Corporate Taxation: Hearing before the Senate Comm. on Finance, S. Hrg. No. 556, 98th Cong., 1st Sess. (1983); ALI, supra note 95, at 32–41; see also Clark, supra note 95 (viewing the inventiveness of the tax bar in responding to new Code provisions as part of a historical pattern which increases the complexity of tax law but is typical of the evolutionary development of law).
implementing the S-Redemption approach by causing the corporation involved to distribute the requisite dividend a substantial period of time before the seller sells the corporation's stock to the purchaser, thus insulating the dividend from the stock purchase. To the extent this would actually occur under a carefully crafted statute, this argument represents a major objection to a no-choice approach.

There is reason, however, to believe that tax planning would not present an insuperable problem. First, the flexibility needed to evade the statute would probably not exist in many cases. For example, if the statute provided that all distributions made by a corporation to either the purchaser or the seller during a sufficiently long statutory period (for example, the period beginning one year before the stock purchase and ending one year after the stock purchase)\textsuperscript{104} would be treated as made in connection with the bootstrap stock acquisition, the scheduling of distributions to avoid the statute would often not be practicable. On the one hand, neither the seller nor the purchaser might be willing to delay the stock purchase for one year, while, on the other hand, the seller might well be unwilling to leave assets at risk in the then purchaser-controlled corporation for one year following the stock purchase.

Corporate tax planners would probably try to facilitate delaying arrangements by protecting sellers or purchasers in these circumstances through the use of escrow agreements, voting trust agreements, and other contractual arrangements imposing restrictions on the management and operation of the corporation during the interim period. The arrangements, if successful, would tend to undermine a no-choice approach statute. Nonetheless, statutory and regulatory safeguards could reduce the impact of these arrangements. An in terrorem provision would probably be the most effective. For example, in addition to providing a statutory time frame for taxing a distribution as made in connection with a bootstrap stock acquisition, Congress could authorize the Secretary of the Treasury to promulgate regulations that would treat any distribution as made in connection with a bootstrap stock acquisition if its failure to occur during the statutory bootstrap time frame appeared to have been motivated to one degree or another by tax avoidance.\textsuperscript{105}

\textsuperscript{104} Deeming all distributions made within such a sufficiently long period to be made in connection with the bootstrap stock acquisition raises the specter of recharacterizing distributions that are made before the actual stock sale is even contemplated. This issue is discussed in the text accompanying notes 200 and 247.

\textsuperscript{105} The appropriate standard of tax avoidance might require fine tuning. One possibility would be to trigger the provision only if the sole or principal purpose for the timing of the distribution was tax avoidance; this would probably render such a provision useless. Requiring the presence of a significant nontax avoidance purpose to avoid the in terrorem provision would put more teeth in the provision, and generally make it extremely difficult for taxpayers to obtain a private ruling.
There is precedent for granting the Treasury Department such regulatory authority.\textsuperscript{106} A statutory provision of this type, if implemented with appropriate regulations, would not only corral a few attempts to evade a no-choice bootstrap acquisition statute, but by virtue of its focus on tax avoidance motives would also probably preclude taxpayers from obtaining private rulings regarding the nonapplicability of the bootstrap statute.\textsuperscript{107} Since substantial transactions generally involve the greatest measure of tax planning and often depend on the issuance of favorable rulings by the Service,\textsuperscript{108} such a provision would discourage attempts to evade the statute on the part of some of the most planning oriented taxpayers in the most widely publicized transactions. This would reduce any public relations fallout and resulting negative impact on taxpayer compliance that such tax avoidance planning would otherwise produce.

Another statutory safeguard could provide that extraordinary dividends—perhaps on the model of current section 1059\textsuperscript{109}—distributed within a more extended period before or after a stock purchase, be taxed as if made in connection with a bootstrap stock acquisition. Such a provision might be sufficient on its own to protect a no-choice bootstrap statute from end runs, provided the extraordinary dividend threshold were

from the Service as to the provision's nonapplicability. This would reinforce the statute's \textit{in terrorem} effort. See text immediately following.

\textsuperscript{106} See I.R.C. §§ 338(e)(3) (Treasury Secretary authorized to treat certain stock acquisitions as "qualified stock purchases" despite failure to satisfy all statutory requirements), 338(i)(1) (Secretary authorized to promulgate regulations to prevent circumvention of § 338 consistency rules), 7872(c)(1)(E) (Secretary authorized to subject below market loan not described in § 7872(c)(1)(A), (B) or (C) to § 7872 if the loan's interest arrangements have a significant effect on federal tax liability of borrower or lender). Since a no-choice bootstrap statute would be founded on the economic substance of the bootstrap stock acquisition, in whatever form actually implemented, deliberate attempts to fall narrowly within the statutory time frames would not appear to present worrisome tax problems. The Service should not concern itself with taxpayers who seek to assure that their bootstrap stock acquisition receives tax treatment that accords with its economic substance, even if such assurance results from meticulous tax planning. In this respect, a no-choice bootstrap statute would resemble § 7872 rather than § 338. Below market loans always involve a transfer of some value to the borrower; if fair interest is charged, however, no anti-tax avoidance safeguard is necessary because no tax avoidance is present. Section 338, on the other hand, involves an essentially elective choice between two competing corporate law principles, neither of which is clearly controlling from a substantive point of view; consistency rules under § 338 prevent the taxpayer from using both principles, on an inconsistent basis and at the government's expense, with respect to a single acquisition.


\textsuperscript{109} Section 1059 is discussed in text accompanying notes 27–29.
set sufficiently low, or it could operate in tandem with an *in terrorem* provision. An extraordinary dividend provision of this type, by comparison with an *in terrorem* provision, would offer the mixed blessing of not conferring significant discretionary authority on the Service, a mixed blessing in the sense that taxpayers would be spared further Service regulatory overreaching, but would find it much easier to engage in overreaching of their own (planning to avoid the effect of the bootstrap statute). The enactment of an extraordinary dividend provision would also allow use of a shorter basic time frame—for instance, six months instead of one year—in the bootstrap statute, thus reducing the likelihood that the bootstrap statute would treat an unrelated distribution as if it were made in connection with the bootstrap stock acquisition.\(^{200}\)

Even if a small number of taxpayers could successfully plan around a no-choice bootstrap stock acquisition statute, the no-choice approach would still offer institutional advantages with respect to the large number of participants in bootstrap stock acquisitions who proceed without the benefit of sophisticated tax advice.\(^{201}\) There would be few lengthy disputes and little litigation over the tax consequences of such taxpayers' bootstrap stock acquisitions, with a concomitant reduction in compliance, record keeping and administrative costs. Furthermore, to the extent a no-choice approach would reflect the expectations of less sophisticated taxpayers as to the tax treatment of their bootstrap stock acquisitions, their expectations would not be disappointed. This would hopefully enhance the confidence of these taxpayers in the federal income tax system and would have a munificent effect on taxpayer compliance in general.

Finally, subtler concerns argue against the view that a no-choice bootstrap statute, if otherwise desirable, should nonetheless be rejected because tax lawyers might be able to plan around it in some cases. Failing to enact a no-choice statute for such a reason would represent nothing less than a total abdication of legislative responsibility. Federal tax law is a creature of Congress; Congress must play the lead role in overseeing and directing its development. Only Congress can, and should, respond to the confusion and the missteps that result when continually evolving tax avoidance efforts meet with similarly evolving Service responses in hard cases decided by judges who must necessarily focus on the case at hand, rather than on broader legal principles and tax policy.\(^{202}\) Absent congressional direction, a judiciary confronted

\(^{200}\) See text accompanying note 152 (problem discussed in context of beneficial ownership test), text accompanying notes 237–38, 247–48 (problem discussed as issue in designing bootstrap statute).

\(^{201}\) See, for example, the saga of unwary purchasers victimized by the primary unconditional obligation test's constructive dividend treatment, in the text accompanying notes 111–19.

\(^{202}\) Compare what Clark says:
with such cases and the three current alternatives for taxing bootstrap stock acquisitions cannot be expected to pick out a clear set of rational legal rules. Instead, sophisticated tax planners would continue to hold sway, providing advice on structuring bootstrap stock acquisitions to those with the time for planning and the resources to pay for advice; other taxpayers, unaware of choices that could be made, would continue to carry out their transactions in ignorance and would sometimes run afoul of the Service. Congress should attempt the remedy because its abdication of responsibility would indicate that the tax system, in this context, is unworthy of public confidence. That the remedy, a no-choice statute, might be only 90% effective is no justification for failing to act.208

Furthermore, the problems associated with unwanted tax planning would probably arise under the election approach as well. For example, as under a no-choice approach, a statutory time frame would also be needed under the election approach to indicate the distributions eligible for elective treatment. Tax planning efforts (and their associated costs) aimed at assuring that distributions would fall inside or outside the statutory period for elective treatment could be expected to follow, albeit to a lesser extent than under a no-choice statute. Statutory and regulatory responses would then be required to respond to this tax planning; the current consistency rules of section 338, rules with few equals when it comes to complexity, exemplify the responses that would be required. In this respect, therefore, contrary to initial appearances and the conventional wisdom of some practitioners, a no-choice approach would be only marginally more problematical than an election approach.

The potential institutional benefits of a no-choice approach are mani-

208 Cf. Mapes v. United States, 576 F.2d 896, 904 (Ct. Cl.), cert. denied, 439 U.S. 1046 (1978) ("the legislature is entitled to make reforms on a piecemeal basis, and solve one inequity at a time," referring to congressional tax relief for unmarried taxpayers which failed to deal with the "marriage penalty" problem).
fold: reductions in legal uncertainty, litigation, and costs and time for compliance, planning, and record keeping, and increased confidence in and compliance with the tax laws. These benefits would not be without costs. A no-choice statute would be moderately complex,\textsuperscript{204} although not unusually complex by tax law standards. This statutory complexity should not be viewed in a vacuum, however, because a no-choice statute with appropriate safeguards against tax avoidance would render largely irrelevant the current law's three alternative tax characterizations for bootstrap transactions and the current law's unsound judicial doctrines. Hence, it is unclear whether adoption of a no-choice statute would, on balance, reduce or increase the tax law's complexity. Even if a no-choice statute increases the complexity of the tax law, however, this increased complexity would help achieve other important ends, including both the institutional benefits alluded to and the taxation of all bootstrap stock acquisitions, in whatever form implemented, according to a regime reflecting their economic substance and economic equivalence. The advantages that would flow from enacting an appropriate no-choice statute would far outweigh the possible increase in tax law complexity thus occasioned. Hence, complexity concerns should not stand in the way of a no-choice statute,\textsuperscript{205} although every effort should be made to avoid unnecessary complexity in designing the statute.

Assuming a no-choice approach would offer substantial advantages over the pure form approach or the election approach, these advantages would be most fully realized under a no-choice approach which most closely tracked both (1) the expectations of the largest number of participants, particularly less sophisticated participants, in bootstrap stock acquisitions, and (2) the substance of those acquisitions. Taxpayer expectations are important because taxpayer compliance depends, in the first instance, on taxpayers filing tax returns that accurately report their transactions, a practice most likely to occur when transactions are taxed as taxpayers expect them to be taxed. Furthermore, disappointed expectations lead to frustrated dealings with the Service, litigation, and lower levels of public confidence in the tax system, all of which probably undermine overall taxpayer compliance. In general, then, enactment of a no-choice statute which is consistent with most taxpayers' expectations would generally produce the largest benefit from an institutional point of view.

\textsuperscript{204} Issues that an S-Redemption approach statute would have to address are discussed in the text accompanying notes 229–54. These issues do not differ materially from similar issues addressed elsewhere in the corporate tax law and present no particularly unusual problems of statutory craftsmanship other than the usual problem of exactly where to draw the particular lines (for example, what time frame should be the lynchpin of the statute's application).

\textsuperscript{205} See supra text accompanying notes 172–74.
The P-Dividend approach clearly does not reflect the tax results expected by taxpayers in bootstrap stock acquisitions. No seller is likely to expect his sale of stock to produce taxable income to the purchaser, whether or not in the form of a dividend, unless the transaction follows a P-Dividend Plan. However, as noted previously,\textsuperscript{206} the P-Dividend Plan tax alternative rarely offers a real advantage to a purchaser, and is unlikely to be deliberately chosen.\textsuperscript{207} In addition, the P-Dividend Plan alternative usually leads to imposition of an unwarranted dividend tax on an individual purchaser. Indeed, much of the second part of this article examined attempts by the Service to impose such a tax despite the absence of a P-Dividend Plan or attempts by taxpayers to resist the tax with respect to a transaction following a P-Dividend Plan pattern.\textsuperscript{208}

Taxpayers probably do not expect taxation of a bootstrap stock acquisition to follow the P-Dividend approach because the P-Dividend approach does not reflect the substance of a bootstrap stock acquisition. Assuming the previous example—\(S\) owns all of the common stock of \(C\) which is worth \$100,000, \$30,000 of which represents cash—\(P\) has three formal alternatives for acquiring \(C\) stripped of its cash for a net outlay of \$70,000.\textsuperscript{209} However \(P\) makes the acquisition, it is not realistic to treat \(P\) as acquiring \(C\) for \$100,000, which then becomes his cost basis in \(C\), and receiving a \$30,000 dividend distribution.\textsuperscript{210} This is the treatment that the P-Dividend approach would mandate. Instead, treating the steps in a bootstrap stock acquisition as integrally related parts of a single transaction, \(P\), in each case, has acquired \(C\) for a net cost of \$70,000, which should be \(P\)'s basis in his \(C\) stock, and any distribution in connection with the transaction can only be properly taxed to \(S\). The P-Dividend approach would not reflect this substance, but would yield an artificial construct. For this reason and the resulting frustration of taxpayer expectations to which the P-Dividend approach would lead, the P-Dividend approach should be rejected.

The S-Dividend and S-Redemption approaches each probably represent the expectations of some taxpayers. Incorporated sellers presumably expect distributions they receive in connection with bootstrap stock

\textsuperscript{206} See supra text accompanying notes 32–34.
\textsuperscript{207} Purchasers sought P-Dividend Plan treatment in the tax avoidance situations at which § 1059—discussed in notes 27–29—is directed. These situations, however, were not really in the nature of typical bootstrap stock acquisitions inasmuch as they envisioned sale of the acquired stock within one year.
\textsuperscript{208} See supra notes 81–82 (taxpayer attempts to resist tax). Most of the second part deals with Service attempts to impose the tax.
\textsuperscript{209} See supra text accompanying notes 1–3.
\textsuperscript{210} Tax avoidance based on a coupling of this unrealistic scenario with a relatively quick sale of stock by \(P\) led to the enactment of § 1059, discussed in notes 27–29.
acquisitions to receive the same advantageous treatment as other dividends, that is, they presumably expect such distributions to be eligible for the dividends received deduction of section 243 or for elimination from the seller's gross income under the consolidated return regulations, the tax consequences generated by the S-Dividend approach.\footnote{211} Noncorporate sellers, on the other hand, generally expect distributions made to them in conjunction with bootstrap stock acquisitions to qualify for capital gain treatment under the S-Redemption approach.\footnote{212} Most purchasers are probably indifferent, the tax difference to them not being of immediate consequence.\footnote{213} Some corporate sellers may realize, of course, that inasmuch as distribution proceeds in this context are part of the total package of payments to be received for the stock sold, the distribution proceeds are more akin to proceeds from the sale of the stock than they are to typical dividend distributions. Nonetheless, taxpayer expectations seem divided as between the S-Redemption approach and the S-Dividend approach, with perhaps a slight tilt in the former direction.

This makes the substance of the transaction all the more important. Deciding whether the S-Redemption approach or the S-Dividend approach would best reflect the substance of a bootstrap stock acquisition requires some conception of what typically distinguishes a dividend from a redemption for tax purposes. Dividends generally represent distributions of corporate earnings and profits to an ongoing shareholder—a shareholder whose relationship with the corporation continues essentially undiminished after the distribution.\footnote{214} Statutory provisions calling for dividend treatment in situations in which the corporate-shareholder relationship ends, or is substantially reduced, invariably involve attempts to protect this central dividend concept. For example, section 302 sometimes treats a redemption that terminates the shareholder's direct ownership of stock in the corporation as a dividend for tax purposes because of the redeemed shareholder's continuing relationship to the corporation through stock owned by parties related to him.\footnote{215}

\footnote{211 Supra note 71.}
\footnote{212 Supra note 72.}
\footnote{213 Supra text accompanying notes 17–19.}
\footnote{214 See, e.g., Waterman S.S. Corp v. Commissioner, 430 F.2d 1185, 1195 (5th Cir. 1970) ("concept of a dividend as a distribution of earnings and profits made in the context of an ongoing corporation-shareholder relationship"), cert. denied, 401 U.S. 939 (1971).}
\footnote{215 See I.R.C. §§ 302(c)(1), 318 (treating redeemed shareholder as owner of stock held by related parties in determining application of § 302(b) provisions pertaining to nontax dividend treatment of redemptions). Section 302(c)(2) permits the redeemed shareholder to cut off attribution to him of stock held by statutorily related family members if he files a waiver agreement with the Service, retains no interest in the corporation other than as a creditor, does not acquire any such...}
A redemption taxed as a redemption under section 302(a), and thus treated as a capital gain or loss transaction, produces a substantial reduction in, or a termination of, the shareholder's proportionate interest in the corporation. Such a redemption is conceptually analogous to a sale or exchange; to the extent a shareholder sells his stock in a corporation, his ongoing relationship with the corporation has terminated. The shareholder receives the redemption proceeds in exchange for part or all of his interest as a shareholder, and the corporation transfers the redemption proceeds to the shareholder in exchange for a cancellation of its liability in form to the shareholder.\textsuperscript{216}

The above discussion indicates that a distribution received by a seller as part of a bootstrap stock acquisition clearly falls into the sale-redemption category, as opposed to the dividend category, when the constructive stock ownership rules do not apply. The distribution, whether in form a dividend or a redemption, is one step in a plan to terminate the seller's relationship with the corporation.\textsuperscript{217} The seller is not receiving a distribution of the corporation's earnings and profits as an ongoing shareholder; rather, he is receiving the distribution as part of the price for terminating his relationship with the corporation. Hence, only the S-Redemption approach would tax bootstrap stock acquisitions in accordance with their substance.

There are, however, certain possible objections to the S-Redemption approach. First, it allows an individual seller to remove earnings and profits from the corporation without any taxation of a dividend. Commentators have long criticized the corporate-shareholder tax system for allowing a shareholder to convert his share of corporate earnings into capital gain by selling his stock, having his stock redeemed, or participating in a corporate liquidation.\textsuperscript{218} This objection to the S-Redemption approach, however, is more appropriately addressed to the tax treatment of redemptions and liquidations generally than it is to the propriety of treating all distributions in conjunction with bootstrap stock acquisitions interest (except by inheriting stock) within ten years of the redemption, and satisfies certain anti-avoidance requirements. This provision, in effect, allows a redeemed shareholder who terminates his relationship with the corporation to a degree greater than that demonstrated by merely terminating his stock ownership to override the family relationship stock ownership attribution rules.

\textsuperscript{216} For the concept of a liability in form, see Eisner v. Macomber, 252 U.S. 189, 209 (1920). The tax law treats the cancellation of the liability in form as meaningless when a redemption is essentially equivalent to a dividend, but this simply reflects the tax law's focus on substance in the face of corporate law emphasis on form. See supra note 95.

\textsuperscript{217} Curiously, the propriety of examining the distribution in light of the bootstrap plan is already established in S-Redemption Plan cases. Indeed, the sequence in which the redemption and sale take place is irrelevant. See supra note 2.

\textsuperscript{218} See authorities cited supra note 95.
as redemptions. That is, the corporate-shareholder tax system might well be improved by treating all corporate distributions made out of earnings and profits, whether in a redemption, a liquidation, or otherwise, as dividends to the shareholders. The current system, however, does not so treat all such corporate distributions. As long as the tax system distinguishes redemptions from dividends, distributions to sellers in connection with bootstrap stock acquisitions belong in the redemption category.

Another objection to the S-Redemption approach is that it would destroy the "present conformity between dividends in taxable transactions and dividends in tax-free reorganizations." 210 This objection assumes that consistent application of an S-Redemption approach would require that a dividend declared by the acquired company prior to a stock-for-stock exchange be treated as consideration other than voting stock paid by the acquiring company. This consideration would then disqualify the exchange from receiving reorganization treatment under section 368(a)(1)(B), the consideration being in violation of the solely for voting stock requirement. By contrast, under current law, a dividend declared prior to a stock-for-stock exchange would not be treated as consideration other than voting stock paid by the acquiring company; therefore, it would not undermine the stock-for-stock exchange's tax-free reorganization treatment. It is, however, by no means clear that consistent application of the S-Redemption approach would require a dividend declared prior to a stock-for-stock exchange to be treated as consideration other than voting stock paid by the acquiring company. If such a distribution resulted in a net reduction in the acquired company's assets and was not funded directly or indirectly by the acquiring company, treating it as consideration paid by the acquiring company would seem inappropriate. 220

Furthermore, this objection assumes the desirability of conformity between taxable transactions and tax-free reorganizations, a dubious assumption. When a seller, pursuant to a bootstrap stock acquisition, receives a distribution in either dividend or redemption form from the corporation whose stock is to be sold, the plan envisions the complete termination of

210 Kingson, supra note 69, at 867 n.30.
220 If the dividend distributed in connection with an alleged tax-free reorganization is financed by funds from the acquiring corporation, it should be treated as consideration for § 368(a)(1)(B) purposes. This is consistent with the result in Waterman S.S. Corp. v. Commissioner, 430 F.2d 1185 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971). Where there is net fresh investment in the corporation as a result of the various bootstrap-related or reorganization-related transactions, it is necessary to separate the effect of the fresh investment from the other transactions to arrive at a consistent and appropriate tax treatment for the transactions. For an exhaustive analysis of this problem, see Coven, The Relevance of Fresh Investment to the Characterization of Corporate Distributions and Adjustments, 38 Tax L. Rev. 419 (1983).
the seller's relationship with the corporation; this is what supports adopting the S-Redemption approach. The shareholder of an acquired corporation who participates in a stock-for-stock exchange retains a continuing relationship with and interest in the business of the acquired corporation through the stock he receives in the acquiring corporation.\textsuperscript{221} His investment remains in the new corporal entity in a form that section 368(a)(1)(B), in effect, treats as a continuation of the acquired corporation from his point of view. It is therefore appropriate, in some circumstances, to treat a pre-exchange distribution to such a shareholder as a dividend from the acquired corporation, rather than as part of the consideration received on a sale or exchange of his stock in the acquired corporation, because the distribution represents earnings and profits of a corporate business in which he continues to maintain an ongoing equity interest through his stock in the acquiring corporation. Hence, the lack of conformity that would result between the taxation of dividends as redemptions in bootstrap stock acquisitions and the taxation of dividends as dividends in tax-free reorganizations is not a persuasive reason to reject the S-Redemption approach.

Two commentators who would apparently accept the S-Redemption approach for individual sellers argue that the policy of avoiding double corporate level taxation requires, or at least should permit, treating any distributions to corporate sellers otherwise eligible for the section 243 (a)(3) 100\% dividends received deduction as dividends.\textsuperscript{222} This argument is premised on the antidouble corporate level taxation policy underlying both the 100\% dividends received deduction and a parent corporation's ability to eliminate from gross income a dividend received from a subsidiary with which it files a consolidated return.\textsuperscript{223} This policy calls for preventing taxation of the subsidiary's earnings, taxable when earned by the subsidiary, at a second corporate level, that of the parent. Since the S-Redemption approach would not characterize a bootstrap-related distribution as a dividend to the selling parent, but would instead characterize it as a taxable capital-gain-generating redemption, the S-Redemption approach would arguably result in a second tax (this time, at the parent level) with respect to the earnings of the sold subsidiary.

This problem, however, is much more limited in scope than initially appears. First, the consolidated return regulations require a parent filing

\textsuperscript{221} Cf. Staff of Joint Comm. on Tax'n, 99th Cong., 1st Sess., Tax Reform Proposals: Corporate Taxation 63–64 (1985) (offering this rationale as a reason to repeal the so-called dividend within gain limitation on boot dividends in connection with reorganizations).

\textsuperscript{222} Schaffer & Gordon, Taxing Intercorporate Dividends Received as Part of the Sale of a Subsidiary, 30 Tax Law. 727 (1977).

\textsuperscript{223} See supra notes 15–16 (dividends received deduction), 26 (elimination of dividend on consolidated return).
consolidated returns with its subsidiary to increase its basis in its stock in the subsidiary by its allocable share of the subsidiary's undistributed earnings and profits for the taxable year. As a result, the S-Redemption approach would not produce double taxation whenever consolidated returns are filed, because the parent's increased basis in the subsidiary's stock would reduce the parent's gain on the aggregate redemption-bootstrap transaction by the parent's allocable share of the subsidiary's previously taxed earnings. Second, a parent and a wholly-owned subsidiary that have not previously filed consolidated returns may so file for the year of sale, electing through a deemed dividend procedure to increase the parent's basis in its subsidiary's stock by the amount of the subsidiary's undistributed earnings and profits from preconsolidation years. This increase in the basis of a parent's stock in its subsidiary would also prevent double taxation of the subsidiary's earnings under the S-Redemption approach.

The problem, however, arises if (1) the deemed dividend procedure is not available because there are minority shareholders or (2) the affiliated group does not want to file a consolidated return. These are certainly situations that merit consideration in light of the policy underlying section 243(a)(3)—relief from double corporate level taxation. However, the S-Dividend approach for corporate sellers in bootstrap stock acquisitions (or some approach that allows these sellers a choice) does not seem to be the appropriate form for this relief. Rather, an extension of the consolidated return deemed dividend procedure or some other procedure for increasing the parent's basis in its subsidiary's stock would seem more appropriate.

The S-Dividend approach for a corporate seller in a bootstrap stock acquisition would be less desirable than a basis adjustment approach for

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225 The regulations allow this by authorizing the parent and subsidiary to elect to treat themselves as if the subsidiary distributed all of its previously accumulated earnings and profits on the first day of the taxable year, and the parent then immediately contributed the amount deemed distributed back to the subsidiary as a contribution to capital. Reg. § 1.1502–32(f)(2).

226 See Schaffer & Gordon, Taxing Intercorporate Dividends Received as Part of the Sale of a Subsidiary, 30 Tax Law. 727, 738–41 (1977). In particular, the consolidated return election will affect future years if the parent owns other subsidiaries.

227 See Blum, Taxing the Corporate Shareholder—Some Old Problems Reconsidered, 53 Taxes 217 (1975), suggesting that the amount realized by a parent on the sale of its subsidiary's stock should be reduced by a constructive dividend equal to the parent's allocable portion of the subsidiary's earnings during the period under the parent's control (less actual dividend distributions). Otherwise, Professor Blum argues for gain or loss recognition on the sale of stock of a subsidiary. Analogous rules could be applied in a bootstrap stock acquisition context.
two reasons. First, the S-Dividend approach would also result in dividend treatment of dividends not deductible in full under section 243 (a) (3), such as dividends only eligible for the 85% dividends received deduction and dividends from foreign corporations which are not deductible. While the S-Dividend approach could be narrowly circumscribed to preclude its application to these cases, it would be easier and more direct to provide for an appropriate adjustment to a parent's basis in its subsidiary's stock to prevent double taxation of subsidiary earnings. To the extent the anti-double taxation policy is viewed as also extending to situations in which a dividend distribution would only qualify for the 85% dividends received deduction, a basis adjustment approach would be more complex. However, current law does not extend this policy to corporate sales of stock in non-80% owned corporations (or to redemptions of such stock from corporate holders) by providing partial relief from capital gain treatment of these sales (or redemptions) to reflect the taxation of earnings to the corporation whose stock has been sold. There seems to be no particular reason to apply the policy to the analogous termination of a corporate seller's interest in a non-80% owned corporation through a bootstrap stock acquisition by allowing dividend treatment of amounts directly received by the corporate seller from the corporation.

Second, if the S-Dividend approach were adopted for corporate sellers in bootstrap stock acquisitions and the S-Redemption approach were adopted for individual sellers, two different and wholly inconsistent rules would apply in essentially analogous circumstances, and could apply to a single transaction involving both an individual seller and a corporate seller. This would lead to a more complex statute than uniform application of the S-Redemption approach and would tend to undermine the institutional advantages—such as clarity and public confidence in the tax law—that a uniform S-Redemption approach could hopefully bring. A basis adjustment approach to the corporate seller's double taxation problem would not create this inconsistency and would simply extend already existing legal principles. Statutory consistency and the resulting legal elegance would be preferable to additional complication.

Implementing the S-Redemption Approach

This part of the article reviews and makes recommendations about the principal issues that must be addressed in implementing the S-Redemption approach. In drafting a statute, a number of choices must always be

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228 Allowing a 100% dividends received deduction in all cases, as Professor Blum proposes, would eliminate this problem. *Id.*
made about where to draw lines. That close cases may fall on one side or another of a given line is not of great importance because those cases are by definition close, that is, substantively not falling clearly on either side of the line. It is a mistake of emphasis to be overly concerned about the classification of close cases.\textsuperscript{229} Recommendations about line drawing in the discussion that follows should be considered in this light.

A statute implementing the S-Redemption approach need not address bootstrap stock acquisitions carried out according to an S-Redemption Plan. Instead, the statute must provide for the taxation of S-Dividend Plan and P-Dividend Plan transactions according to the S-Redemption Plan model. These transactions should generally be treated as involving a redemption of the seller's stock for all purposes of the Code; treating a single transaction in different ways under different provisions of the Code causes unnecessary confusion. In particular, the transaction should be treated as a redemption of stock from the seller, not only for purposes of computing the seller's capital gain or loss from the deemed redemption,\textsuperscript{230} but also in determining the purchaser's basis in the stock purchased,\textsuperscript{231} the effect of the distribution on the corporation's earnings and profits,\textsuperscript{232} and, if appreciated property is distributed, the recognition or nonrecognition of gain to the corporation as a result of the distribution under sections 311(d) and 338(c)(2).\textsuperscript{233} Similarly, the transaction should be treated as a redemption of the seller's stock in applying the pertinent provisions of subchapter S, such as sections 1368 (relating to distributions made by an S corporation) and 1371 (relating to earnings and profits of an S corporation). The author would also extend redemption treatment to dividend-form distributions made in order to avoid the accumulated earnings tax or the personal holding company tax, although these may be unusual contexts calling for some relief.\textsuperscript{234}

In the case of a bootstrap stock acquisition carried out pursuant to a

\textsuperscript{229} The case method of instruction employed by many law teachers (including the author) may contribute to this mistaken emphasis.

\textsuperscript{230} See supra text accompanying notes 6–8. Treatment of the dividend distribution as a redemption does not necessarily imply that it will receive capital gain or loss treatment. As a redemption, the distribution may be essentially equivalent to a dividend and taxed as a dividend by virtue of §§ 302(d), 301 and 316.

\textsuperscript{231} See supra text following note 8.

\textsuperscript{232} See supra text accompanying notes 9–10, 17–19.

\textsuperscript{233} See supra text accompanying notes 41–62.

\textsuperscript{234} Such relief could be granted either in the form of an amendment to § 562, which would provide that the distributions involved be treated as dividends to the extent of the corporation's earnings and profits for purposes of computing the § 561 dividends paid deduction, or as an exception to the bootstrap statute. The former approach would probably make it easy to avoid the personal holding company tax or the accumulated earnings tax by selling the stock of the corporation involved, while the latter approach seems unjustifiable when compared with a distribution in redemption form for which the current statute grants no relief.
P-Dividend Plan, however, the statutory recharacterization of the transaction would only affect a seller’s tax treatment if the amount deemed received from a redemption of part of the seller’s stock would fail section 302(b)’s nondividend equivalency standards and would therefore be treated as a dividend instead of as a capital gain or loss. This could occur if the seller were deemed under section 318 to own stock actually owned by others, or if the seller only sold a small percentage of a large holding of the corporation’s stock. The latter case would generally be excluded from the statute’s coverage by a provision which would limit the statute’s application to transfers of significant percentage interests.\footnote{Infra text accompanying note 243.}

The former situation may be sufficiently insignificant to ignore because few bootstrap stock acquisitions, particularly those involving related parties, follow the P-Dividend Plan model. Nonetheless, if redemptions must run the gamut of section 318 to qualify for capital gain treatment, deemed redemptions resulting from P-Dividend Plan bootstrap stock acquisitions should not be immune from section 318’s stock ownership attribution rules.\footnote{For example, if a trust for the benefit of the selling shareholder owns 75\% of the stock (none of which is involved in the transaction), the purchaser’s share of a dividend paid at the time of the stock purchase to the purchaser (along with the trust) should be treated as actually paid directly to the seller as redemption proceeds. The proceeds would then probably be treated as a dividend to the seller by virtue of §§ 302(d) and 301, assuming sufficient earnings and profits.}

The statute should indicate clearly which dividends it will treat as “essentially equivalent to redemptions.” A statutory line founded upon the relative contemporaneity of a dividend distribution and a stock purchase would provide a clear line for including dividends under the statute and a base for expanding the statute’s tentacles by way of an \textit{in terrorem} provision,\footnote{See supra text accompanying notes 195–98.} an extraordinary dividend provision,\footnote{See supra text accompanying note 199.} or some other special provision to reach dividends distributed earlier or later to avoid the bootstrap statute’s effect. Focusing on the timing of the actual dividend distribution and the timing of the actual stock purchase is essential.\footnote{Cf. I.R.C. §§ 333, 337 (focusing on timing of actual liquidation).} The beneficial ownership and dividend record date concepts are not helpful in the context of the closely held corporation;\footnote{See supra text accompanying notes 137–52.} to the extent taxpayers attempt to manipulate these concepts in trying to avoid the statute’s application, statutory safeguards should snare them.

Clearly, the statute cannot potentially apply whenever dividends are distributed in close temporal proximity to a sale of a few shares of the underlying stock. Relatively small purchases of stock (in percentage
terms) should be excluded from the bootstrap statute's application. As a result, the statute would not apply to most transactions involving the stock of publicly traded corporations or to other transactions involving insignificant minority shareholders, most of whom can be presumed to play no role in any decision to declare dividends in connection with a stock sale.\textsuperscript{241} In addition, it might be advisable to exclude transactions in the stock of publicly traded corporations from the statute's application altogether, except perhaps for cases where a majority of a public corporation's stock is acquired by a single purchaser or related purchasers during the statutory time frame. The statute must aggregate stock purchases by a single purchaser from a single seller which occur within a given statutory period in order to determine the applicability of the small purchase exception; otherwise, a sizeable transaction could escape the statute's ambit by being divided into numerous small purchases. Similarly, in applying the small purchase exception, sellers and purchasers must be deemed to own stock owned by parties related to them within the meaning of section 318; otherwise, a single purchase otherwise covered by the statute could be divided into several excepted small purchases made by related purchasers or from related sellers. Some thought should probably also be given to whether several corporate purchasers or sellers acting jointly should have their transactions treated as one in applying the small purchase exception.\textsuperscript{242}

Taking these aggregation and ownership attribution principles into account, the purchase of shares of stock possessing either more than 20% of a corporation's total combined voting power or representing more than 20% of the value of a corporation's total outstanding common stock seems an appropriate touchstone for the bootstrap statute's application. No other party could possess 80% control of a corporation in these circumstances. On the other hand, a purchaser's acquisition of a small percentage interest in a closely held corporation, 20% or less, is much less likely to relate to a relatively contemporaneous dividend distribution.\textsuperscript{243} An appropriate level for a small purchase exception, therefore, seems to be 20%. The percentage should probably be measured after the related constructive redemption takes place.

All purchases by a single purchaser (and related parties) from a single

\textsuperscript{241} Whether more substantial shareholders should be permitted to establish their lack of control over the payment of dividends is a more difficult question. The potential for litigation of such an issue and its relative lack of importance, however, strongly suggest that the bootstrap statute should foreclose the question and not allow substantial shareholders to prove their way out of the statute. See supra text accompanying note 152.

\textsuperscript{242} Compare I.R.C. § 246A(c)(2) (definition of "portfolio stock") (discussed in note 24).

\textsuperscript{243} See supra note 241.
seller (and related parties) made within a one-year period should be aggregated in determining whether the 20% threshold figure has been reached so as to trigger the statute’s application to related dividend distributions. This one-year period necessarily represents a compromise between a time frame which would cover every case in which a series of small purchases is made pursuant to a single overall plan—an unlimited time frame—and the realities of commercial transactions as well as the feasibility of relating purchases over an extended period to one another. Indeed, the Code has adopted the one-year time frame in similar contexts.\textsuperscript{244} If a one-year period is too short to preclude tax avoidance planning in this context, either (1) a longer time period could be adopted or (2) \textit{in terrorem} authority could be given to the Treasury to, in effect, overlook the time frame in applying the bootstrap provision in defined tax avoidance contexts.\textsuperscript{245}

If a stock purchase meeting the above criteria has occurred, then the bootstrap statute must indicate which dividend distributions to the purchaser or seller are to be recharacterized as redemptions. In this respect, section 338’s consistency period \textsuperscript{246} offers a useful analogy: The statute should apply to dividends distributed during the period beginning one year before the first purchase of stock which, together with other such purchases, constitutes a more than 20% stock purchase and ending one year after the last such purchase of stock. The author’s discussion of this issue with various practitioners suggests that some practitioners would consider a three-month period more appropriate because it would facilitate planning. Such an approach would be unfortunate. Facilitating tax planning is not an appropriate goal when the planning involved is largely aimed at avoiding the proper taxation of a transaction, that is, the taxation of a bootstrap stock acquisition in a manner other than that provided in the statute. On the other hand, the longer time frame might treat distributions as made in connection with a wholly unrelated stock sale. Since it seems clearly impractical to allow taxpayers the possibility of proving their way out of the bootstrap statute by establishing that a distribution and stock sale are unrelated, experience may dictate a time frame of less than one year.\textsuperscript{247} In this event, the statute should include statutory anti-avoidance safeguards of the sort alluded to earlier.\textsuperscript{248}

Nor should the unsatisfactory experience with section 338’s consis-

\textsuperscript{244} See, e.g., I.R.C. §§ 338(h)(1) (definition of 12-month acquisition period), 1059(c)(3)(B) (aggregation of dividends received within one year if total exceeds 20% of taxpayer’s adjusted basis in stock).

\textsuperscript{245} See supra notes 194–98 (similar suggestion regarding timing of dividend distributions relative to stock purchase).

\textsuperscript{246} See supra note 59.

\textsuperscript{247} See supra note 241.

\textsuperscript{248} Supra text accompanying notes 195–200.
tency rules counsel against the use in a bootstrap statute of a consistency period analogous to that used in section 338. The proposed bootstrap statute would differ in a fundamental way from section 338. Section 338 reflects the tax law’s schizophrenic view of the transactions to which it applies: The law is, by and large, split over whether the target corporation’s corporate entity ought to be (1) recognized or (2) at least partly ignored. Section 338 does not imply the theoretical superiority of either position. Many of the problems with section 338 reflect an effort to limit the taxpayer’s ability to manipulate this schizophrenic aspect of tax jurisprudence at the government’s expense. The proposed bootstrap statute, however, would reflect an effort to tax all bootstrap stock acquisitions in accordance with their substance. With one set of tax consequences deemed appropriate for all of these acquisitions, the statute would neither require nor be dependent upon complex technical consistency rules similar to those found in section 338. Less complex anti-avoidance provisions favoring bootstrap treatment for ambiguous or tax avoidance oriented transactions would suffice. Indeed, statutory provisions which focus on the substance of specific categories of corporate-shareholder transactions—such as sections 302 and 306—seem to have caused less difficulty in practice than those—the corporate reorganization provisions, for example—whose historically based focus on substance is now buried in a welter of formalism.

When such a bootstrap statute treats a dividend distribution to the seller or purchaser as made in redemption of some or all of the seller’s stock, the statute must provide a method for ascertaining the amount of the seller’s adjusted basis in the stock attributable to the redeemed shares in order to properly compute the seller’s gain or loss on the redemption, and the number of shares deemed redeemed in order to determine the proper charge to the corporation’s earnings and profits. In a situation involving only a single class of common stock, the statute should provide that the number of shares of common stock considered redeemed is the total number of shares of common stock in the corporation owned by the seller immediately before all transactions treated as part of the stock acquisition, multiplied by a fraction. The fraction should be the amount of consideration distributed in the form of the dividend which the statute recharacterizes as a redemption divided by the total consideration received by the seller from both the corporation and the purchaser. Basis should be apportioned to the stock deemed redeemed on a similar basis. In cases involving multiple class capital structures it will probably be necessary to allow resolution of

249 See supra text accompanying note 6.
250 See I.R.C. § 312(n)(8), (discussed in note 9 and accompanying text).
251 In a P-Dividend Plan transaction, all of this consideration would come from the corporation.
these issues by regulation or on a case-by-case basis; however, the reported decisions suggest that corporations with more than one class of stock represent a very small proportion of bootstrap stock acquisitions.

One possible objection to the suggested formula is its failure to account for the fact that the dividend distribution may occur more than a year before or after some individual stock purchases, the purchase prices of which enter into the formula. This objection suggests the formula ought to take account of the time value of money in comparing distributions, purchases, and redemptions that occur at different points in time. Inasmuch as all pertinent transactions usually occur over a relatively short period (a few years, at most) in the bootstrap context, this objection might be viewed as overly pedantic and technical.\footnote{252} Nonetheless, the possibility of incorporating into the formula factors adjusting all dollar amounts for the time value of money should be evaluated in designing the statute.

This article has focussed on distributions made in connection with sales of stock. The principles of a bootstrap statute should be equally applicable, however, to certain other dispositions of stock, such as gifts and charitable contributions. A shareholder who receives a dividend distribution immediately before donating all of his stock to a charitable organization is not receiving a distribution of corporate profits as an ongoing shareholder, but as part of a plan to terminate his interest. Hence, the dividend distribution should be treated as made in redemption of a portion of the shareholder's stock.\footnote{253} In this charitable contribution situation, however, the bootstrap statute should determine the basis of the stock deemed redeemed and the number of shares deemed redeemed in accordance with the principles of section 1011(b), which allocates the adjusted basis of property sold to a charity in a bargain sale between the portion of the stock sold and the portion of the stock donated. Consideration should be given to applying a similar rule in a gift context. In other respects, all dispositions of stock, other than in certain tax-free transactions, for instance, corporate reorganizations,\footnote{254} should be treated as purchases under a bootstrap statute.

\textbf{Conclusion}

This article examines the tax treatment of bootstrap stock acquisitions. Current law taxes these acquisitions in accordance with any one of

\footnote{252} This would be particularly true if real and nominal interest rates were not as high as they are today. Indeed, the concern about the time value of money in recent years undoubtedly stems from the high level of interest rates.

\footnote{253} A taxpayer's argument to this effect was rejected in Reitz v. Commissioner, 61 T.C. 443 (1974), \textit{aff'd per unpublished opinion} (5th Cir., Jan. 23, 1975).

\footnote{254} \textit{See supra} notes 219–20 and accompanying text.
three different sets of tax consequences. Taxpayers are therefore able to plan bootstrap transactions that will result in the most advantageous aggregate tax treatment. The Service, unhappy with this situation, has successfully used certain judicial doctrines to recharacterize some of these transactions for tax purposes, usually, in an attempt to treat the purchaser as a dividend recipient. The resulting losers are chiefly less sophisticated taxpayers, usually purchasers, who unwittingly fail to plan around the resulting legal traps. The judicial doctrines that have produced these traps—the primary unconditional obligation test, the beneficial ownership test, and the economic substance test—are all fundamentally unsound. Furthermore, the three alternative tax treatments available under current law for bootstrap stock acquisitions elevate form over substance inasmuch as all of these acquisitions are economically equivalent, absent tax effects. Institutional considerations and fundamental tax considerations suggest that all acquisitions should be treated for tax purposes as if carried out by a redemption of a portion of the seller's stock in combination with a sale of the seller's remaining stock to the purchaser. A statute providing for this treatment would be moderately, but not overly, complex, as suggested by this article's recommendations. Such a bootstrap statute would offer substantial advantages over current law.
<table>
<thead>
<tr>
<th>Taxpayer</th>
<th>Tax Consequences</th>
<th>Plan 1</th>
<th>Plan 2</th>
<th>Plan 3</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td>$S$</td>
<td>INCOME</td>
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<td>$50,000 Capital Gain</td>
<td>$80,000 Capital Gain</td>
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<td>$16,000, Individual</td>
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<td>$25,000, Individual</td>
<td>$16,000, Individual</td>
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<td></td>
<td>$22,400, Corporation</td>
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<td>$14,000, Corporation *</td>
<td>$22,400, Corporation</td>
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<tr>
<td>$P$</td>
<td>INCOME</td>
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<td>ZERO</td>
<td>$30,000, Dividend</td>
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<tr>
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<td>MAXIMUM TAX</td>
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<td>ZERO</td>
<td>$15,000, Individual</td>
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<tr>
<td></td>
<td>POST-PLAN BASIS</td>
<td>$70,000</td>
<td>$70,000</td>
<td>$100,000 Individually/</td>
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<tr>
<td>IN C STOCK</td>
<td></td>
<td></td>
<td></td>
<td>Corporation ** or</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>ZERO Corporation ***</td>
</tr>
<tr>
<td></td>
<td>POST-PLAN EARNINGS AND PROFITS</td>
<td>$35,000</td>
<td>$20,000</td>
<td>$70,000 Corporation ***</td>
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<tr>
<td>$C$</td>
<td></td>
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<td></td>
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</tr>
</tbody>
</table>

* This assumes a 100% dividends received deduction.
** This assumes an 85% dividends received deduction.
*** These figures assume $P$ and $C$ file a consolidated return for the taxable year in which the plan 3 dividend is distributed.