TAXATION OF STOCK RIGHTS

Stock rights or stock warrants are subscription rights issued by a corporation to its shareholders offering the opportunity to purchase shares of its own stock or that of another corporation. They are used primarily as a means of raising capital, but the cost of exercise is normally set below the market value of the shares. Thus, the shareholder may receive a benefit either by exercise or by a sale of the stock rights themselves.

The tax effects to the shareholder flowing from the distribution of rights as opposed to the stock itself are by no means settled. A recent example will serve to illustrate this uncertainty. In 1961, the Pacific Telephone and Telegraph Company (Pacific) created the Pacific Northwest Bell Telephone Company (Northwest). Pacific transferred a portion of its operating properties to Northwest in exchange for all of the 30,460,000 shares of the latter's common stock. Pacific then distributed stock rights to its common and preferred shareholders to purchase fifty-seven per cent of this Northwest common stock at sixteen dollars per share. The plan called for American Telephone and Telegraph Company, which owned approximately ninety per cent of Pacific's common stock and approximately seventy-eight per cent of the preferred, to exercise its rights immediately so as to own fifty-one per cent of the 30,460,000 Northwest shares outstanding. The stock rights held by other shareholders were to be exercised within thirty days.

Pacific intended to offer to its shareholders the remaining forty-three per cent of the Northwest stock within a three year period. This type of corporate adjustment is known as a spin-off.

In answer to Pacific's request for information regarding the tax effects to its shareholders, the Internal Revenue Service (Commissioner) issued a private-letter ruling concluding that the distribution would have the following tax effect to its shareholders:

First, no taxable income would result to the shareholder upon either receipt or lapse of the stock rights; second, if a shareholder were to sell the stock rights, the entire proceeds would constitute ordinary income; third, the exercise of the stock rights by a noncorporate shareholder would result in dividend income equal to the excess of the fair market value of the Northwest stock at the date of exercise over the amount paid upon exercise; and, fourth, the exercise by a corporate shareholder would result in dividend income equal to the excess of the basis of the

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2 Approximately 900,000 shares were subject to the stock rights held by other shareholders.
3 A spin-off is a corporate division related to the split-up and split-off. A spin-off exists when corporation A transfers part of its assets to corporation B in exchange for B's stock which is then distributed to corporation A's shareholders without surrender of any corporation A stock. A split-up occurs when corporation A, after transferring all of its assets to corporations B and C in exchange for B and C stock, liquidates by distributing the B and C stock to its shareholders in exchange for corporation A stock. A split-off exists when corporation A transfers part of its assets to corporation B in exchange for B's stock which corporation A then distributes to its shareholders in exchange for part of their corporation A stock. See MERTENS, FEDERAL INCOME TAXATION § 20.100 (1961).
4 Letter Ruling Directed to the Pacific Telephone & Telegraph Co., June 28, 1961. In response to the request of Pacific, the Commissioner issued a re-ruling on Nov. 15, 1962, pertaining to the tax effects of the transaction to the Pacific shareholders. See appendix.
5 Northwest stock sold for about $27 per share, resulting in dividend income of $11 per share. CCH CAP. CHGS. REP., NEW MATTER 1838 (1961).
Northwest stock in the hands of Pacific at the time of exercise over the amount paid upon exercise.6

The Commissioner's determination, when contrasted with the tax effect of a direct distribution of stock, raises serious questions. His position would allow the shareholder to receive the stock rights tax free; similar treatment would be afforded the receipt of stock itself only if the distribution met the requirements of section 355 of the Internal Revenue Code of 1954.7 Whether the Commissioner's position was based upon section 355 or simply upon the proposition that stock rights are not taxable on issue is not clear.8 Since in our example these requirements apparently would have been satisfied had the stock been distributed directly,9 the use of stock rights instead made no difference to the shareholders.

Use of the stock rights device seems to have made a significant difference in the tax treatment resulting upon sale or exercise of the rights by the shareholder. The Commissioner ruled that the entire proceeds received upon sale would be ordinary income. Yet, if the Northwest stock had been distributed directly, ordinarily any gain10 resulting upon a subsequent sale of the stock would have been taxed as capital.11 Where section 306 applies, ordinary income treatment of a sale of stock rights is proper.12 But it does not appear that the Commissioner relied

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6 The difference in treatment between the noncorporate and corporate shareholder is due to the 85% intercorporate dividend deduction. See Inr. Rev. Code of 1954, § 243(a). Ordinarily, the market value of the property distributed is higher than the basis of the property in the hands of the distributing corporation. To permit a corporate shareholder to increase the basis of property received while only reporting 15% of the increase would permit a loophole and unfairly benefit the corporate shareholder. Therefore, the lesser of the fair market value or the basis of the property in the hands of the distributing corporation is considered to be the amount of the distribution. See Inr. Rev. Code of 1954, § 301. In the Pacific example, Pacific's basis of the Northwest stock was less than the price of the exercise.

7 The tax free receipt provided by § 355 requires a distribution of "stock or securities" of a controlled corporation in a transaction fulfilling the following requirements: first, active conduct of a business for five years prior to the distribution; second, use of the transaction not principally as a device for the distribution of earnings and profits; and third, distribution of either all of the stock and securities of the controlled corporation or an amount that satisfies the Commissioner that no tax avoidance purpose is involved.

8 See Letter Rulings, supra note 4.

9 See note 7 supra. Stock was distributed, active business was conducted for five years prior to the distribution, there was no intent to distribute earnings and profits, and all the Northwest stock was to be distributed within three years. Since § 355(a)(1)(D) requires the distributing corporation (Pacific) to distribute all of the Northwest stock, three years may be too long a period of time to qualify for a reorganization. But see National Bank of Commerce v. United States, 87 F. Supp. 302 (W.D. Tenn. 1949), aff'd per curiam, 180 F.2d (6th Cir.), cert. denied, 340 U.S. 822 (1950) (four years did not disqualify).

10 Upon receipt of a stock dividend, the basis of the underlying stock is allocated between it and the distributed stock. Inr. Rev. Code of 1954, § 358. When the stock is sold, the proceeds in excess of the allocated basis is the gain subject to tax.

11 Normally, the Pacific common stock in the hands of the shareholders would be a capital asset. See Inr. Rev. Code of 1954, §§ 358, 1221; Corn Prods. Ref. Co. v. Commissioner, 350 U.S. 46 (1955). Compare § 306 which provides that the amount realized from a subsequent sale of preferred stock received as a result of a rights distribution is treated as ordinary income. See text accompanying note 49 infra.

12 Pursuant to § 306, the amount realized upon a sale of a stock right will produce ordinary income if the right is any of the following: a stock right other than a common stock right which is issued to a common shareholder where, by reason of § 305(a), the right was received tax free; a preferred stock right received tax free in a reorganization; or a stock right whose basis is determined by reference to that of a stock right meeting either of the previous requirements.
upon that section for his result and its applicability to the Pacific transaction
would seem doubtful.\footnote{13} Finally, the Commissioner determined that the shareholders
would receive dividend income upon receipt of stock through exercise of the
rights even though a direct distribution of Northwest stock probably would have
been tax free.\footnote{14}

This comment will examine the Commissioner's determination of the tax effects
of the use of the stock rights technique in the Pacific transaction. By considering
the pre-1954 Code case law, the 1954 Code, and the policy underlying the reor-
ganization sections, other possible tax results will be explored, both in a reorgan-
ization and nonreorganization situation.

I
WHERE A REORGANIZATION IS NOT PRESENT

The use of stock rights in a corporate adjustment may prevent the transaction
from qualifying as a reorganization for tax purposes. Since this consequence can
be discussed more meaningfully in connection with an examination of the reorgan-
ization sections of the 1954 Code, it is postponed until that point is reached.\footnote{15}
Attention will now be focused on the use of stock rights unaccompanied by such
corporate adjustments.

A. Rights To Purchase Stock of Another Corporation
(The Northwest Type of Rights)

1. The Law Prior to the 1954 Code

Prior to the 1954 Code, stock rights were not dealt with in the revenue acts
directly. It was left to the courts to apply general revenue policy in order to deter-
mine the tax effect of a stock rights distribution. In \textit{Palmer v. Commissioner},\footnote{16}
the Supreme Court held that the Northwest type of rights were not taxable on
receipt. The Court likened such stock rights not to property but to "options or
continuing offers," representing only "potential sources of income to the stock-
holders through sale or exercise of the rights."\footnote{17} Thus, only upon exercise might
a distribution of corporate property take place and possible dividend treatment
result to the shareholder. It was further held that no dividend income resulted to
the shareholder in \textit{Palmer} upon exercise. The price set for exercise represented the

\footnote{13} The requirements for the operation of § 306 are summarized in note 12 \textit{supra}. Since the
stock subject to the rights in the Pacific transaction was common stock, § 306 could apply to
produce ordinary income treatment only if the stock right was issued to a preferred shareholder
and was received tax free by reason of § 305(a). Although Pacific preferred shareholders
were the recipients of stock rights, their receipt could not be tax free \textit{by reason of} § 305(a).
That section only provides for tax free receipt of rights to acquire stock in the distributing
corporation, \textit{i.e.}, Pacific stock. Thus, the Commissioner's determination that the entire pro-
cceeds received upon sale would constitute ordinary income can find no support in § 306, even
as to the preferred shareholder. Since the letter ruling made no reference to § 306 and the
common and preferred shareholders were treated similarly, it is doubtful that the determina-
tion was based upon that section.

\footnote{14} See note 7 \textit{supra} and accompanying text.

\footnote{15} See text accompanying notes 55-61 \textit{infra}.

\footnote{16} 302 U.S. 63 (1937).

\footnote{17} \textit{Id.} at 71.
reason that the issue of the stock rights was therefore not intended to be a means of distributing earnings to the shareholders, but only a means of effecting a sale of the stock. Therefore, exercise by the shareholder was a mere purchase of stock; no dividend income resulted even though the stock’s value at exercise exceeded the price paid.

The Second Circuit, in *Choate v. Commissioner*, followed *Palmer* by finding no income on receipt of the Northwest type of rights. But the court held that dividend income resulted upon exercise because the circumstances indicated an intention to distribute a dividend. The amount taxed was the spread (the difference between the cost of exercise and the market value of the stock to be received) when the stock right was exercised or when the stock right was issued, whichever was lower. The spread was used rather than the value of the stock right itself because under *Palmer* taxability upon exercise depended upon whether the corporation intended the distribution to be a dividend. The presence of a spread determined that such an intent existed. The Commissioner argued that the spread should be taxed under the broad terms of the income provisions of the code, rather than as a dividend. The court, in rejecting such an approach, held that since the presence of the intention to distribute a dividend created a tax, the tax must be a dividend.

One year after the *Choate* decision the question of the tax consequences to a shareholder resulting from a sale of stock rights reached the Second Circuit in *Gibson v. Commissioner*. The court found that dividend income resulted to the extent of the market value of the rights at receipt. The balance of the proceeds received from the sale was taxed as a capital gain, though this issue was not argued before the court.

Thus, prior to the 1954 Code, the courts held the shareholder who received stock rights where earnings and profits were available subject to tax as follows: first, no tax on receipt or lapse of the rights; second, taxed as a dividend to the extent of the spread on exercise; and third, taxed as a dividend to the extent of the market value of the stock rights at receipt when the stock rights are sold.

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18 129 F.2d 684 (2d Cir. 1942).

19 The Northwest rights cost $16 to exercise. The fair market value of the Northwest stock at issuance of the right or at exercise of the right less $16 would be the spread.

20 It has been suggested that the value of the rights (the sale price on a stock exchange) is the better yardstick. See Lowndes, *The Taxation of Stock Dividends and Stock Rights*, 96 U. PA. L. REV. 147 (1947); Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 YALE L.J. 1017 (1957).

21 *But see G.C.M. 25063*, 1947-1 CUM. BULL. 45, where the Commissioner finds ordinary income to the extent of the proceeds of the sale of rights, citing *Choate* and *Palmer*. The *Gibson* approach is a more satisfactory one because the market value of the rights on receipt should be recognized as a dividend when the rights are sold. This result follows from the *Choate* analogy of dividend income on exercise of the rights.

24 The existence of earnings and profits is essential for a distribution of property to result in dividend income. To the extent the fair market value of the property distributed exceeds the earnings and profits, the distribution is not a dividend, *Int. Rev. Code of 1954*, § 316(a). That portion of the distribution which is not a dividend decreases the basis of the shareholder’s stock. The excess over the basis of the stock is treated as a gain from a sale or exchange of property, *Int. Rev. Code of 1954*, § 301(c) (3) (A).
2. The Effect of the 1954 Code

Whether the 1954 Code has effected a change in the prior law depends upon the view taken of the *Palmer* decision. The language that may be subject to varying interpretations is as follows:

The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition. . . . They are at most options or continuing offers, potential sources of income to stockholders through sale or the exercise of the rights. Taxable income might result from their sale, but distribution of corporate property could take place only on their exercise. . . .

One possible interpretation of this language would be that although the stock rights are "property" with an ascertainable value, the issuance of the stock rights was not a distribution of corporate assets. A dividend would then be defined as "any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings and profits." Since the stock itself was the corporate asset and a distribution of corporate property would occur only upon exercise of the stock rights, there could be no distribution out of its earnings and profits and thus no dividend until that time. Such a reading of *Palmer* would provide authority for the Commissioner's determination of tax free receipt of the Northwest type of rights in the Pacific transaction. The statutory definition of a dividend under the 1954 Code is almost identical to that with which the Court dealt in *Palmer.*

It is doubtful, however, that this is a proper interpretation of the Court's opinion. The statute provided then, as it does today, that "every distribution is made out of earnings or profits" to the extent earnings and profits exist. To assume that stock rights are "property" and yet can be distributed without that distribution being "made out of earnings or profits" would be contrary to the explicit command of the statute. Moreover, a distribution of property to a shareholder that is not a dividend was treated then, as it is today, as a return of capital. Since neither a dividend nor a return of capital occurred in *Palmer,* such an interpretation is not proper.

There is another and more reasonable interpretation of the *Palmer* opinion which, in contrast, would render its result consistent with the statutory framework then existing. *Palmer* can be read as holding that stock rights are not "property" at all, but mere options or continuing offers. And, since the statutory definition of a dividend required a distribution of property, a distribution of stock rights

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25 302 U.S. at 71. (Citations omitted.) It is submitted that a decrease in net worth does occur when stock rights are distributed. At issue of the rights, an obligation against the stock is created just as if the stock was pledged for a loan. In the Pacific transaction, upon issue of the stock rights, a corporate obligation arose to deliver $27 worth of stock for $16 plus the rights. Pacific's net worth was, in a very practical sense, decreased by $11 per share of Northwest stock subject to the rights.


could not be a dividend or a return of capital. Thus, the stock rights would be received tax free.

If this is the meaning of the Court's opinion the case will not provide support for the Commissioner’s determination of tax free receipt in the Pacific example. Section 317, newly created in the 1954 Code, has vitiated this "no property" rationale of Palmer that prevented dividend treatment. By this section property is now defined to be "money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." The express exception of rights to acquire stock in the distributing corporation clearly indicates that all other stock rights, e.g., the Northwest type of rights, are within the definition of property. Since section 316 defines a dividend as a distribution of property out of the corporation's earnings and profits, a distribution of the Northwest type of rights would result in dividend income upon receipt under section 301 to the extent earnings and profits are available.30

This latter interpretation of Palmer would seem to be the correct one. And extending this reading into the 1954 Code would normally produce dividend income treatment to the shareholder upon receipt. If, however, at the time of distribution valuation of the rights is impossible, tax will probably be postponed until a value can be ascertained. Such a result has been reached where stock rights were distributed to employees of the corporation.31 But as dictum in Palmer contained in the portion of the opinion quoted earlier32 recognized, shareholder's stock rights are ordinarily traded on the stock exchanges and therefore have a readily ascertainable market value.

There is another provision in the 1954 Code that indicates that the Northwest type of rights were intended to be taxable upon receipt. Under section 305(a) stock rights in the issuing corporation maintain tax free receipt except for section 305(b) stock rights, which discharge preference dividends or allow the shareholder to elect to receive other property instead of the stock rights. The special treatment of section 305(b) stock rights specifically directs that some rights be taxed on receipt.33 Extending this congressional direction to include the Northwest type of rights that do not specifically receive tax free treatment under section 305(a) is but a logical progression of reasoning reaching a result consistent with prior analysis.34 To what extent the result under section 305(b) directs a change in the law of tax free receipt of all stock rights is, however, yet to be judicially determined.

It is this writer's belief that the 1954 Code has effected a change in the prior law and that a distribution of the Northwest type of stock rights will result in dividend income to the shareholders, assuming that the rights can be valued and earnings and profits are available. If this conclusion is correct, a lapse of the Northwest type of rights would result in a loss being recognized to the extent of the dividend income recognized on receipt. Section 165, which allows a deduction

30 Section 301 provides that the amount of a distribution of property that is a dividend as defined in § 316 shall be included in gross income. That portion which is not a dividend (the excess of the earnings and profits) is a return of capital. Int. Rev. Code of 1954, § 301(c)(2).
32 See text accompanying note 25 supra.
33 See text accompanying note 45 infra.
34 See text accompanying note 27 supra.
for securities that become worthless during the taxable year, includes stock rights within the meaning of "security." By lapse the stock rights would become worthless and be treated as a loss from the sale or exchange of a capital asset.

If the Northwest type of rights are taxed on receipt as a dividend, upon exercise there would probably not be a gain or loss. The cost of exercise, if any, added to the amount of the dividend already recognized would be the basis of the stock rights. Since the fair market value of the stock received on exercise would usually be the same as the basis of the rights, there would be no gain or loss on exercise. Sale of the rights would produce gain or loss only when there was a market value variation between receipt and the subsequent sale, since the dividend recognized upon receipt would equal the market value at that time.

B. Rights To Purchase Stock of the Issuing Corporation
(The Pacific Type of Rights)

1. The Law Prior to the 1954 Code

Prior to the 1954 Code, rights to purchase stock of the issuing corporation were nontaxable on receipt if the stock subject to the stock rights could have been received tax free. The general rule that taxability of a stock dividend depended upon whether the proportionate interest of the shareholder in the corporation had been altered also applied to stock rights. Where the proportionate interest of the shareholder in the corporate entity remained essentially the same, the stock rights were treated as if the stock subject to the rights had been distributed. For example, if a corporation distributed rights to purchase common stock to its common shareholders, receipt and exercise of the stock rights were tax free and their sale produced capital gain or ordinary income, as would the sale of the stock subject to the rights. Basis was allocated between the old stock and the stock rights. If the proportionate interest of the shareholders in the corporate entity after the exercise of the stock rights was essentially different from his former interest, the stock rights were treated as a distribution of the Northwest type of rights. An example would be a corporate distribution to preferred shareholders of rights to purchase common stock.

2. The Effect of the 1954 Code

Congress eliminated the proportionate interest test by adding section 305 to the 1954 Code. Section 305(a) provides that "gross income does not include the amount of any distribution made by a corporation to its shareholders, with respect to the stock of such corporation, in its stock or in rights to acquire its stock."

35 For purposes of § 165(g), the term "security" means: "(A) a share of stock in a corporation; (B) a right to subscribe for, or to receive, a share of stock in a corporation."

36 Section 1234, dealing with a loss due to the failure to exercise an option to buy or sell property, would probably not apply to a stock rights situation that is covered so clearly by § 165(g)(2)(B). See Whiteside, Income Tax Consequences of Distributions of Stock Rights to Shareholders, 66 YALE L.J. 1017, 1031 (1957).


40 Ibid.


42 Choate v. Commissioner, 129 F.2d 684 (2d Cir. 1942).
Thus, with two exceptions to be discussed presently, taxation is prevented when the stock rights are received. Consequently, an allocation of basis must be made. If the stock rights are sold, a gain is recognized to the extent the proceeds exceed the allocated basis. Unless the stock subject to the rights is preferred stock, the gain recognized on a sale of the rights will usually be a capital gain. If the stock rights are exercised no gain is recognized and the allocated basis plus the cost of exercise becomes the basis for the stock acquired.

The general rule for the Pacific type of rights is a mechanical test excluding the old proportionate interest test entirely. As previously indicated, however, this general rule precluding taxation upon receipt of the Pacific type of rights is subject to two exceptions.

Section 305(b) prevents section 305(a) from applying where the distribution is made to discharge preference dividends for the present or preceding taxable year, or where the shareholder can elect to receive other corporate property in lieu of the stock rights. If the stock rights fall within either exception they are treated as "a distribution of property to which section 301 applies. . . ." To this extent, the stock rights are taxed like the Northwest type of rights that are treated as a property distribution. Where section 301 applies, the distribution should be taxed on receipt at fair market value as a dividend. It follows that where a dividend was recognized on receipt, a loss would occur if the stock rights lapse. Thus, stock rights within section 305(b) should be taxed as a dividend on receipt at their fair market value rather than deferring tax to the time of exercise or sale.

3. The Operation of Section 306

Either preferred or common stock may be the subject of stock rights. And tax free receipt of all stock rights within section 305(a) will result whether the stock itself is common or preferred. The type of stock is, however, extremely important in determining the character of the gain recognized upon a subsequent sale of the stock received on exercise or a sale of the rights themselves. Under section 306 of the 1954 Code, enacted to meet the problem of the preferred stock bail-out, stock rights to subscribe to preferred stock in the issuing corporation, stock other

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43 INT. REV. CODE OF 1954, § 307. The Treasury regulations allow an allocation only if the rights are exercised or sold. Treas. Reg. § 1.307-1(a) (1955). If the rights lapse, no need for a basis allocation exists for only the underlying stock remains.

44 Usually, the underlying stock is a capital asset in the hands of the shareholder. Whether the underlying stock is a capital asset determines the character of any gain upon sale of the stock rights. See INT. REV. CODE OF 1954, § 1221. If the underlying stock were a capital asset and had been held more than six months when the stock rights were sold, the proceeds from the sale would be a long term capital gain. A holding period of less than six months would produce a short term capital gain. Long term capital gain is subject to an alternative tax treatment, which is not available to a short term capital gain. INT. REV. CODE OF 1954, §§ 1201, 1222. The taxable effects flowing from the use of stock rights covering preferred stock is discussed in the text accompanying notes 49–54 infra. If the underlying stock were not a capital asset, the gain from the sale of the stock rights would be included in gross income as a "gain derived from dealings in property." INT. REV. CODE OF 1954, § 61(a) (3).

45 INT. REV. CODE OF 1954, § 305(b).

46 See note 26 supra and accompanying text.

47 See text accompanying note 27 supra.

48 Where the 305(b) stock rights are taxed on receipt as a dividend, a subsequent exercise or sale would produce a tax effect similar to those of the Northwest type of rights. See text following note 36 supra.

than common stock received in a reorganization, and stock having a basis determined by reference to the basis of section 306 stock, issued to common shareholders are "tainted." The amount realized from a subsequent disposition of tainted stock rights is treated as a gain from a sale of property which is not a capital asset, \(\text{i.e.}\), as ordinary income. Section 306 limits this tainting effect to the ratable share of the amount which would have been a dividend if the corporation had distributed money in an amount equal to the fair market value of the rights at the time of distribution. Any excess is treated as a gain from the sale of the stock rights. No loss is recognized.

C. Use of Stock Rights in the Absence of a Reorganization—Conclusion

It can be seen that Congress has left no doubt as to the treatment to be afforded the use of rights to acquire stock in the issuing corporation not incident to a reorganization. Unless they discharge preference dividends or unless other property may, at the election of the shareholder, be received instead, the Pacific type of rights are received tax free. And no gain or loss will occur upon lapse or exercise. Only upon a sale of the rights will a gain be recognized and its character will, in the absence of section 306 application, ordinarily be capital.

The tax treatment of the Northwest type of rights under the 1954 Code is, on the other hand, far from clear. As previously discussed, the tax result may well depend upon which interpretation of the Supreme Court's opinion in Palmer is the proper one. It is submitted that the tax free receipt afforded by that decision is no longer a correct result under the 1954 Code, and dividend income should result upon receipt of the Northwest type of rights. But whether the courts will accept the language of the 1954 Code as a change in the prior law without a more express direction to that effect remains to be seen.

II

DISTRIBUTION OF STOCK RIGHTS PURSUANT TO A PLAN OF REORGANIZATION

A change of corporate structure is often accompanied by a need for new capital. The use of stock rights not only furnishes a convenient method to fulfill that need but also serves to induce the shareholder to agree to the proposed alteration; this is because the cost of exercise is usually established attractively below the market

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50 For the purposes of this discussion, the exclusions of §306(a)(2) (redemption of "tainted" stock), §306(b)(1)(A) (termination of shareholder's interest other than by a redemption), and §306(c)(2) (no earnings and profits available at the time of the distribution) are assumed to be inapplicable.

51 The importance of this distinction between ordinary income and dividend income for the individual shareholder is explained in the applicability of §34, which provides a tax credit of 4% of the dividends included in gross income, and §116, which provides that the first $50 of dividend income is excluded from gross income. The corporate shareholder receives a deduction in an amount equal to 85% of the dividends included in income under §243. The corporate shareholder also receives a tax credit for its pro rata share of income tax paid on income of foreign corporations under §901. The corporate payee of the dividend reduces its earnings and profits by the amount of the dividend under §312.


value of the stock subject to the stock rights. Thus, a distribution of stock rights will often form a part of management's plan for a reorganization. Unfortunately, the tax effect of such a use of stock rights under the 1954 Code is not clear. The primary difficulty is whether the distribution of stock rights will be treated as one of stock itself or as a distribution of "other property."

A. Stock Rights as "Other Property"

1. Reorganization May be Precluded

If stock rights are to be treated as "other property" rather than "stock," some corporate adjustments may be prevented from being "reorganizations" at all. A "D" reorganization is a transfer of corporate assets to a second corporation accompanied by a distribution of "stock or securities" with either the first corporation, its shareholders, or a combination of the two in control of the second corporation.\(^5\) A distribution of "other property" will preclude a "D" reorganization if there is no accompanying distribution of "stock or securities." In the Pacific transaction the Commissioner may have treated the Northwest rights as "other property,"\(^5\) and because "stock or securities" were not also distributed a "D" reorganization was not present.

A "B" reorganization is the acquisition of controlling stock in the second corporation by the first corporation in exchange solely for all or part of its voting stock.\(^5\) The "C" reorganization is the acquisition of substantially all of the properties of the second corporation in exchange solely for all or part of the first corporation's voting stock.\(^5\) Since the presence of "other property" would not meet the requirement of "solely" voting stock, the "B" reorganization and, if more than twenty per cent of "other property" is distributed, the "C" reorganization are precluded by a distribution of stock rights.\(^6\)

As will be developed in detail later,\(^6\) treatment of stock rights as "other property" to preclude a reorganization would seem to be contrary to the policy expressed by the reorganization sections\(^6\) and against the congressional intent evidenced by section 306.\(^6\)

A reorganization may be present even though stock rights are distributed. Only the "B" reorganization absolutely prohibits anything other than voting stock to be distributed. The "A" and "E" reorganizations permit "other property" to be distributed whether or not stock or securities are also distributed. The "C" reorganization permits a twenty per cent distribution of other property along with "solely voting stock." The "D" reorganization requires "stock or

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\(^5\) INT. REV. CODE OF 1954, § 368(a) (1) (D).
\(^7\) This conclusion is only a surmise. Nevertheless, the Treasury regulations take the position that stock rights or warrants are not "stock or securities." Treas. Reg. §§ 1.351-1(a) (1)(ii), 1.354-1(e), 1.355-1(a). The logical conclusion following from such a position is that stock rights or warrants are therefore "other property."
\(^8\) INT. REV. CODE OF 1954, § 368(a) (1) (B).
\(^9\) INT. REV. CODE OF 1954, § 368(a) (1) (C). The "solely voting stock" requirement is eased to permit a 20% other property distribution. INT. REV. CODE OF 1954, § 368(a) (2) (B). To this extent, stock rights would not preclude a "C" reorganization.
\(^11\) See text accompanying notes 72–81 infra.
\(^12\) See text accompanying notes 73–79 infra.
\(^13\) See note 80 infra and accompanying text.
"securities" to accompany an other property distribution. Thus, stock rights can be distributed pursuant to some reorganizations even if such rights are treated as other property.

2. Assuming a Reorganization is Present

Where a corporate adjustment qualifies as a reorganization, a distribution of stock to the shareholder will ordinarily be received tax free, whether the stock is that of the distributing corporation or that of another corporate party to the reorganization.64 The basis of the underlying stock would be allocated between the stock received and the underlying stock.65 The holding period of the distributed stock would be the same as the underlying stock.66 The gain or loss upon a sale of the distributed stock would be treated as capital gain unless the stock was "tainted."67

If, however, the Northwest type of rights are used and are treated as "other property," the shareholder would be taxed upon receipt. If the shareholder exchanges his stock or securities in a reorganization and in addition receives "other property," he is taxed upon receipt to the extent of the gain. If the exchange "has the effect of a distribution of a dividend," the gain is taxed as dividend income to the extent of the shareholder's ratable share of earnings and profits.68 Any gain not treated as a dividend is considered to be a gain from the exchange of property.69 If there is no exchange involved but only a distribution of "stock and securities" and "other property," the fair market value of that "other property" received is treated as a distribution to which section 301 applies.70

If the Pacific type of stock rights are used, the presence or absence of a reorganization and whether or not they are treated as "other property" makes no difference in the tax effects to the shareholder. As we have already seen, section

64 The tax treatment of stock, securities, or other property received by a shareholder pursuant to a reorganization is governed by §§354, 355, and 356. Section 354 requires an exchange solely of "stock or securities" for "stock or securities." Where the requisite exchange exists and only securities are received, or an excess of securities is received, or property other than stock or securities is received, §356 applies. In a "D" reorganization all or substantially all of the transferor corporation's assets must be acquired by the transferee corporation, and the stock, securities, and other property received by the transferor must be distributed to its shareholders or §354 would not apply. If §354 does not apply to the "D" reorganization, §355 must apply or the transaction does not receive reorganization treatment.

Section 355 applies to a distribution solely of "stock" of a controlled corporation. An exchange is only required if "securities" are involved. Section 356 governs the treatment of "other property" distributed along with "stock or securities" qualifying under §354 or §355.

65 INT. REV. CODE of 1954, §358.
66 INT. REV. CODE of 1954, §1223(1). But see appendix, holding (5).
67 The character of the underlying stock would be determinative of this issue. INT. REV. CODE of 1954, §§306, 1221. See text accompanying note 49 supra.

68 INT. REV. CODE of 1954, §356(a)(2). The courts have not settled what the test is to determine when a distribution has this effect. See Commissioner v. Estate of Bedford, 325 U.S. 283 (1945); Hawkinson v. Commissioner, 235 F.2d 747 (2d Cir. 1956); Idaho Power Co. v. United States, 142 Ct. Cl. 534, 161 F. Supp. 807 (1958). See also Darrell, The Scope of Commissioner v. Bedford Estate, 24 TAXES 266 (1946); Wittenstein, Boot Distributions and Section 112(c)(2): A Re-examination, 8 TAX L. REV. 63 (1952). The Commissioner seems to have adopted an automatic rule that all "other property" distributions have the effect of a dividend. See Treas. Reg. §1.356-1(c), example (1) (1955).

69 INT. REV. CODE of 1954, §356(a)(2). The gain would be either capital or ordinary depending upon the character of the other stock exchanged.

70 INT. REV. CODE of 1954, §356(b).
305(a) provides that a distribution to shareholders of rights to acquire stock in the issuing corporation is received tax free.\textsuperscript{71} The result is the same where stock itself is distributed. Thus, only as to the Northwest type of rights does a treatment as “other property” in a reorganization situation give rise to treatment that is different from that which would flow from a distribution of stock itself. Such a result is not, however, automatically compelled, for stock rights may, consistently with the 1954 Code and present case law, be treated as “stock.”

B. Stock Rights as “Stock”

As previously discussed, a shareholder receiving stock in a reorganization will ordinarily not be taxed upon receipt. Treating the receipt of stock rights similarly in a reorganization is consistent with the basic policy expressed by the reorganization sections of the code. There are two possible courses open to the courts to achieve this result.

1. The Step Transaction Doctrine

The first alternative would be the application of the step transaction doctrine to equate the receipt of stock rights to the receipt of stock itself. The step transaction doctrine is only a judicial device expressing the familiar principle that in applying the income tax laws, the substance rather than the form of the transaction is controlling.\textsuperscript{72} The substance of a transaction is determined by considering “the situation as it existed at the beginning and the end of the series of steps as well as the object sought to be accomplished, the means employed, and the relation between the various steps.”\textsuperscript{73}

This doctrine is no stranger to questions of taxation concerning the corporate adjustments skirting the reorganization sections of the code. It has been used to find the presence of an integrated transaction and hence the existence of a reorganization.\textsuperscript{74} A reorganization has been found by its use to permit a tax free distribution of stock to the shareholders.\textsuperscript{75} The Supreme Court has described the policy underlying the reorganization sections of the code as follows: “Where, pursuant to a plan, the interest of the shareholder of a corporation continues to be definitely represented in substantial measure in a new or different one, then . . . the exchange is to be treated as one not giving rise to present gains or loss. . . .”\textsuperscript{76} Thus, if by use of the step transaction doctrine the transaction appears to be an integrated one which in substance is within this policy of the reorganization provisions, the tax free treatment afforded by those provisions should be applied.

Applying the step transaction doctrine to the Pacific example will demonstrate the usefulness of such an approach in effecting the policy of the reorganization sections. When the Pacific shareholder exercised his rights, he owned approximately the same interest in Northwest assets that he had previously owned as a Pacific shareholder.\textsuperscript{77} If he sold the rights, his interest might not remain sub-

\textsuperscript{71} See text accompanying note 43 supra.

\textsuperscript{72} Starr v. Commissioner, 82 F.2d 964, 968 (4th Cir.), cert. denied, 298 U.S. 680 (1936).

\textsuperscript{73} Walter S. Heller, 2 T.C. 371, 383 (1943).


\textsuperscript{75} Ethel K. Lesser, 26 T.C. 306 (1956).


\textsuperscript{77} The holders of approximately 215,000 preferred shares received stock rights to purchase about 225,000 of the 17,460,000 Northwest shares in this offering. The number was small because
stantially the same. But, this possibility because there is a taxable incident at sale, should not prevent the doctrine from applying to permit tax free receipt. The last step in the transaction, that of distributing the stock upon exercise, was the same result reached as if stock rights had not been used. The identity of end results reached by different routes is a significant factor in determining whether the step transaction doctrine should apply to ignore the divergence in methods. Although the corporation had increased its cash position by the use of stock rights, and would not have done so if the stock had been distributed directly, it is doubtful that this is an important difference in end result in terms of the policy of the reorganization sections.

If the step transaction doctrine were applied to a distribution of stock rights pursuant to a reorganization, a hindsight test would be used to determine the tax effects to the shareholder. After the period of exercise has passed, the stock or property in the hands of the shareholder at that time would be treated as if it had been received when the stock rights were distributed. If the rights had lapsed, the shareholder would have nothing upon which a tax could be imposed, and thus, no tax would result. If the stock rights had been exercised, the shareholder would have stock which would ordinarily be receivable tax free. If the rights had been sold, the shareholder probably would have cash that may be properly classified as "other property" and taxed as if it had been distributed directly pursuant to the reorganization.

2. Congressional Intent Evidenced in Section 306

There is a second alternative open to the courts to enable them to treat a distribution of stock rights in a reorganization similarly to a distribution of stock. This device is the simple one of recognizing that Congress has expressed an intent that some stock rights be receivable tax free in a reorganization, and extending that intent to cover all stock rights.

In section 306(c), Congress specifically singled out preferred stock received tax free pursuant to a reorganization for special treatment. Section 306(d) provides
that for the purposes of applying section 306: "(1) stock rights shall be treated as stock and (2) stock acquired through the exercise of stock rights shall be treated as stock distributed at the time of the distribution of the stock rights, to the extent of the fair market value of such rights at the time of the distribution." This section treats preferred stock rights as the stock itself. If the rights are exercised, the stock acquired assumes the position of having been distributed instead of rights, to the extent of the fair market value of the rights. This direct reference to tax free reorganizations and stock received without recognition of gain clearly indicates that preferred stock rights are to be received tax free in a reorganization and at least suggests that similar treatment be afforded to all stock rights.81

Carrying this specific indication to its logical conclusion, a distribution of stock rights to a shareholder would be received tax free in the same circumstances as would stock. If the stock rights were exercised, no tax would occur. Sale of "tainted" rights would receive section 306 treatment, i.e., ordinary income. If common stock, Northwest or Pacific, or preferred stock of a corporation not issuing the rights was subject to the rights, capital or ordinary gain would be recognized on a sale of the rights.

The tax effect under the step transaction approach or the treating of stock rights as stock is the same upon receipt, lapse, and exercise of the stock rights. Section 306 "taints" stock rights to purchase preferred stock under either theory. The only difference in tax effect is when the stock rights are sold. Under the step transaction approach, proceeds from the sale of the stock rights would be treated as an "other property" distribution. By treating the stock rights as stock in accordance with the implied congressional intent, a sale of the stock rights would have the same tax effect as a sale of the stock. Since a capital gain would ordinarily be produced by a sale of the stock, a sale of the stock rights would result in identical treatment.

C. Use of Stock Rights in a Reorganization—Conclusion

Where a reorganization is present, the policy permitting tax free corporate adjustments should apply to stock rights transactions. The shareholders' interest remains substantially the same when stock rights are distributed as when the stock itself is distributed. The court-created step transaction doctrine, used to tax the substance of the transaction rather than the form, is one approach available to the stock rights problem. The second approach, extending the congressional intent found in section 306, which treats stock rights to purchase preferred stock as stock, to all stock rights distributed pursuant to a reorganization also resolves the stock rights problem satisfactorily. And until the congressional intent is more explicitly enacted into the code, 82 the courts should be willing to recognize its existence.

Michael Antin*

81 For the purposes of the free receipt of stock in a reorganization, Congress has not drawn a distinction between common or preferred stock. It should not be inferred, therefore, that the congressional intent to permit tax free receipt of preferred stock rights evidenced in § 306 is restricted solely to such rights.

82 It is submitted that Congress could enact a provision similar to § 306(d) in the reorganization section to clarify the existing treatment.

* Member, Class of 1963.
APPENDIX

LETTER RULING DIRECTED TO THE PACIFIC TELEPHONE & TELEGRAPH COMPANY

NOVEMBER 15, 1962

Since the facts upon which the ruling is based are summarized in the text, only the holding is set out here. More complete factual information is available in the Pacific Telephone & Telegraph Prospectus, Sept. 13, 1961.

(1) The receipt by the shareholders of the Pacific Company of rights to purchase shares of stock of the Northwest Company will not result in taxable income to the shareholders.

(2) No taxable income will result to the shareholders of the Pacific Company by reason of holding the above-described rights to purchase shares of stock of the Northwest Company until the date of expiration of the rights, without having exercised, sold or exchanged them.

(3) The full amount realized by the shareholders of the Pacific Company upon the sale or exchange of the above-described rights to purchase shares of stock of the Northwest Company will constitute ordinary income to the shareholder so selling or exchanging the rights.

(4) The receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon the exercise of the above-described rights, in case of each shareholder which is not a corporation, will result in a distribution of property under section 301 of the Code in an amount equal to the excess, if any, of the fair market value of the stock of the Northwest Company at the time of the exercise of the rights over the amount paid for the stock; and, in the case of each shareholder which is a corporation, will result in a distribution of property under section 301 in an amount equal to the excess, if any, of the basis of the stock of the Northwest Company in the hands of the Pacific Company at the time of the exercise of the rights over the amount paid for the stock, assuming the basis of such stock is less than its fair market value.

The amount of the distribution, as determined above, will constitute a dividend to the extent provided for in sections 301(c) and 316 of the Code.

Neither section 346 nor section 355 of the Code will be applicable to the receipt by the shareholders of the Pacific Company of stock of the Northwest Company upon exercise of the above-described rights.

(5) The basis in the hands of the shareholders of the Pacific Company (other than the American Company) of the stock of the Northwest Company received upon the exercise of the rights will, in the case of each shareholder which is not a corporation, be the fair market value of the stock on the date of exercise, and will, in the case of each shareholder which is a corporation, be the basis of the stock of Northwest in the hands of Pacific on the date of exercise, assuming the basis of such stock is less than its fair market value and greater than the purchase price of the stock. The holding period of this stock will begin on the date on which the rights to acquire it are exercised.