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Erratum
Page 478, last paragraph, first line. For "In any event," read "In any event, hopefully, ".

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The Deductibility of Stock Redemption Expenses

Kenneth S. Cohen

Prior to 1970, there were three distinct lines of authority on the question of the deductibility of stock redemption expenses. The three lines of cases did not refer to one another, however, and consequently there was no clear rule on how redemption expenses were to be treated. In 1970 the Supreme Court determined that the origin and character test should be applied to the related area of stock appraisal litigation expenses. Through an extensive case analysis the author attempts to reconcile the previous law and then evaluates the effect of the Supreme Court decisions on that law. He concludes that although prior law may remain largely unaffected by the application of the origin and character test, the advent of a single test could be a clear improvement over the chaos that has existed.

I. INTRODUCTION

When a corporation redeems its own stock, the transaction may be characterized in several ways. First, since the corporation is returning some of its "capital" to its shareholders, every redemption is, in some sense, a partial liquidation, although not necessarily in the same sense as that term is used in section 346 of the Code. Secondly, a redemption may have certain characteristics of a reorganization, again not necessarily in the sense of the statutory definition of section 368, but in the broader sense of a "restructuring of the corporate entity or enterprise." Finally, every

1 The word "redeem" as used in the Internal Revenue Code covers both redeem and repurchase in corporate parlance. See INT. REV. CODE OF 1954, § 317(b).

2 The term "capital" is used in the broad sense of "proprietorship," since the repurchase itself may be "out of" earned surplus or capital surplus with no reduction of stated capital. See, e.g., ABA-ALI MODEL BUS. CORP. ACT § 6 (rev. 1969) [hereinafter cited as MBCA].

3 INT. REV. CODE OF 1954, § 346. Hereinafter, unless otherwise specified, all references to "the Code" or to specific sections are to the Internal Revenue Code of 1954, whether in text or notes.

4 B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 5.07 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE]. In the context of a single corporation, the concept of reorganization usually refers to recapitalization.
redemption may be thought of as a purchase by the corporation of an asset, namely its own stock, though today treasury stock is generally not considered an asset of the corporation. It is because many redemptions seem to fit somehow into all of these categories, yet squarely into none of them, that the courts have had considerable trouble in deciding whether the corporation may deduct or must capitalize the incidental expenses incurred in carrying out a redemption transaction. Indeed, an extensive and confusing body of law has developed on the question.

That body of law was further complicated by the 1970 Supreme Court decisions of \textit{Woodward v. Commissioner} and \textit{United States v. Hilton Hotels Corp.}, which dealt with the related issues surrounding the tax treatment of expenses incurred in litigation undertaken to value the stock of shareholders who dissent from some major corporate action. The primary focus of this article will be on the effect of \textit{Woodward} and \textit{Hilton} upon the prior cases, which can be placed into three general categories: the partial liquidation cases, the simple acquisition cases, and the business purpose cases.


\textsuperscript{6}Such expenses may include legal fees, accounting fees and professional appraisal fees. See Maier, \textit{Deductibility of Expenses Incurred in Corporate Reorganization and Liquidations}, U. So. Cal. 1968 Tax Inst. 253, 274-77.

\textsuperscript{7}No section of the Code specifically covers the problem although several deal with it in a more general fashion. Section 162 allows the deduction of all ordinary and necessary expenses of a trade or business. Section 164(a) allows the deduction of certain state and local taxes. Section 165 allows the deduction of certain losses. Section 248 allows amortization of organizational expenditures. And section 263 prohibits the deduction of most capital expenditures. See Carruthers, \textit{How to Treat the Expenses of Organization, Reorganization and Liquidation}, N.Y.U. 24th Inst. on Fed. Tax. 1055 (1966).


\textsuperscript{9}397 U.S. 572 (1970).

\textsuperscript{10}397 U.S. 580 (1970).}
II. THE PRIOR LAW OF STOCK REDEMPTION EXPENSES

A. The Partial Liquidation Cases

As a general rule, the expenses generated by complete liquidation of a corporation are deductible in the year they are incurred.11 However, expenses of corporate reorganization are generally not deductible and must be capitalized.12 From these principles there developed a line of decisions which have been called the "partial liquidation" cases.13 Their thrust is that if the dominant aspect of a redemption is partial liquidation rather than reorganization, the expenses are deductible. As with most rules where the operative language is "dominant aspect" or the like, the rule has been easier to state than to apply.

The partial liquidation cases began with Mills Estate, Inc. v. Commissioner14 where the corporate taxpayer held all of the stock of another corporation and operated certain improved real estate. The taxpayer sold the real estate and distributed the proceeds of the sale to its shareholders pro rata. In the process, the corporate charter was amended to reduce the capital stock of the corporation.15 The shareholders surrendered 44 percent of their stock in exchange for the proceeds of the real estate sale. The remaining shares were exchanged for an equal number of new shares with the same par value. In the course of the transaction, the corporation incurred legal fees of approximately $20,000, which it claimed as an ordinary deduction.

The Tax Court,16 speaking through Judge Raum, discussed cases dealing with expenses of reorganization and cases dealing with expenses of complete liquidation. The court then stated:

12 There are some exceptions. BITTKER & EUSTICE § 5.07. However, in the context of a recapitalization-reorganization (see note 4 supra) the rule stated in the text seems well established. See, e.g., Missouri-Kansas Pipe Line Co. v. Commissioner, 148 F.2d 460 (3d Cir. 1945); Skenandoa Rayon Corp. v. Commissioner, 122 F.2d 268 (2d Cir.), cert. denied, 314 U.S. 696 (1941).
13 See D. HERWITZ, supra note 8, at 540. Professor Herwitz is the only author to date to explore the fact that there has been more than one line of cases developing in this area.
14 206 F.2d 244 (2d Cir. 1953), rev'd in part, aff'd in part 17 T.C. 910 (1951).
15 The reduction of capital was required by New York law. 206 F.2d at 245. The capital stock of the corporation was reduced from $5,000,000, represented by 50,000 shares of $100 par value, to $2,800,000, represented by 28,000 shares of $100 par value.
16 17 T.C. 910 (1951).
The expenditures involved herein have characteristics that par-
take of both lines of decisions. Petitioner's legal expenses were
undoubtedly incurred in substantial part in order to amend its char-
ter and reduce authorized capitalization, thereby providing for the
acquisition and retirement of its stock followed by the issuance of
new stock in reduced amount. This aspect of the transaction cer-
tainly brings the case within the first line of authority [the reor-
ganization cases]. However, the actual distribution of assets in
partial liquidation was also a significant factor with respect to
which the legal fees were paid, and it is difficult to perceive why
the cost of a partial liquidation should be any the less an ordinary
and necessary business expense than the cost of a complete liquida-
tion.17

The court went on to allocate the legal fees in question, holding,
somewhat arbitrarily, that half were incurred in "reconstituting"18
the stock of the taxpayer and half were incurred in the distribution
of assets. The latter were held to be deductible.19

On appeal, the Second Circuit reversed20 and held that no part
of the expenditure was deductible. After stating that allocation
was improper and that "the entire proceeding must be viewed as a
single transaction",21 the court found that the transaction was "es-
sentially a reorganization — a change in the corporate structure for
the benefit of future operations." The expenses were incurred in
the creation of "an intangible asset . . . its altered corporate struc-
ture; and, as were the costs of its original organization, these ex-
penditures were capital in nature."22

Finally, the court found that since the issue involved the corpo-
ration as opposed to its stockholders, "whether part of what was
done was a partial liquidation under section 115" of the 1939 Code
was irrelevant.23

Responding to the Second Circuit's decision in Mills, the Tax
Court became more cautious in its approach to the problem. Except
for one case24 decided while the appeal in Mills was pending, it

17 Id. at 915.
18 Id.
19 The opinion was reviewed by the court. Two judges dissented, questioning the
rule that expenses of complete liquidation are deductible, but stating that even if such
expenses are deductible, the expenditures in the case at bar were incident to the reor-
ganization of the corporation and not its liquidation. Id.
20 Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953).
21 Id. at 246.
22 Id.
23 Id.
24 Tobacco Prods. Export Corp., 18 T.C. 1100 (1952), modified on other grounds,
21 T.C. 625 (1954), not acquiesced in, 1955-2 CUM. BULL. 11, appeal dismissed per
stipulation, 4 P-H 1955 FED. TAXES § 71,121 (2d Cir. 1955). There, the corporate
taxpayer, which was in the importing business, held approximately 56,000 shares of
uniformly held against the taxpayer. In *Standard Linen Service, Inc.*, the corporate taxpayer operated a laundry and a linen supply business, the latter partially through a wholly-owned subsidiary. The taxpayer liquidated the subsidiary and distributed the linen supply assets to one of the taxpayer's shareholders in exchange for his stock. The shares were cancelled and the corporate charter was amended to reduce the corporation's capital. In denying a deduction for the expenses of the transaction, the Tax Court stated that the taxpayer had failed to show that "no part" of the expenditure "represented the cost of a capital item." Similar language was used by the Tax Court to deny a deduction in *Farmers Union Corp. v. Commissioner*. There the expenses were incurred in the distribution of the inventory and related assets of one of the corporate businesses in exchange for stock held by several shareholders. The test employed in these cases was more restrictive than that implied by the Second Circuit in *Mills*, which required only a showing that the transaction was not "essentially" a reorganization. 

the stock of another corporation, the business of which was unrelated to the taxpayer's. The taxpayer distributed the 56,000 shares together with some cash to its shareholders pro rata in exchange for approximately 90 percent of its own stock. After allocating a certain percentage of the legal and other expenses to abandoned plans of "partial liquidation," the Tax Court, on the authority of its decision in *Mills Estate*, allocated half of the remaining expenses to the distribution of assets and allowed a deduction for that half. After the Second Circuit's reversal of *Mills*, the opinion in *Tobacco Products* was modified, upon the taxpayer's motion relating to another issue. However, the portion of the earlier opinion dealing with the deductibility of the redemption expenses was left undisturbed. 21 T.C. 625 (1954).

21 T.C. 625 (1954).

22 Id. at 1.

23 Id. at 17.

24 P-H Tax Ct. Mem. 1039, 1054 (1960), aff'd, 300 F.2d 197 (9th Cir.), cert. dened, 371 U.S. 861 (1962). In *Farmers Union*, the taxpayer, while retaining its real estate holdings, distributed the inventory and related assets of its mercantile business in exchange for stock held by seven of its 134 stockholders. See also Stephen L. Morrow, 36 P-H Tax Ct. Mem. 1342, 1365 (1967), where the Tax Court denied a deduction for legal expenses on the ground that the taxpayer corporation had failed to show which portion of the expense related to the redemption of its stock and which related to the sale of the balance of its stock by the taxpayer's sole shareholder to a third party. The court also said that, even assuming all of the expenses were related to the redemption, there would still be a failure of proof on the part of the taxpayer "because not every expense of a partial liquidation is deductible as an ordinary and necessary business expense." Id. at 1365 (citing *Standard Linen Service*, 33 T.C. 1 (1959), acquiesced in, 1960-2 CUM. BULL. 7).

25 See text accompanying note 22 supra.
The Tax Court decision in *Farmers Union* was affirmed by the Ninth Circuit.\(^{30}\)

However, one Tax Court holding of nondeductibility in this line of decisions was reversed by the Eighth Circuit. In *Gravois Planing Mill Co. v. Commissioner*,\(^{31}\) Beckemeier, who owned 50 percent of the corporation’s outstanding stock, decided to retire. Pursuant to a preexisting first refusal agreement, he offered his shares to the corporation. After some discussion, it was decided that Beckemeier would sell to one of the three other shareholders, Landgraf, a sufficient number of shares to equalize the stock holdings among the three shareholders. The balance would then be redeemed by the corporation. Since the corporation did not possess sufficient cash to cover the full purchase price of the shares to be redeemed, it was agreed that it would pay for them, in part, with certain improved real estate and with a paid-up life insurance policy on Beckemeier’s life. Beckemeier insisted, and it was agreed, that the corporation lease back the real estate for a period of 10 years. Beckemeier went off the corporation’s payroll, and performance of the agreement proceeded smoothly. Two days later he sold the agreed number of shares to Landgraf. Thereafter, a law firm, which Beckemeier had consulted with respect to his proposed retirement, was retained by the corporation. In the ensuing transactions, Beckemeier’s remaining shares were redeemed and cancelled by the corporation, and the articles of the corporation were amended to reduce its stated capital. The law firm, making no separate charge to Beckemeier, submitted its bill for $2,500 to the corporation, and the corporation paid it.

The Tax Court, in denying a deduction for this expense, saw no essential difference between this case and *Standard Linen*.\(^{32}\) In the main, it felt that the services rendered by the attorneys were “necessary steps in the redemption and cancellation of the stock of Beckemeier and the recapitalization of the corporation.”\(^{33}\) The court also said that some of the fees were paid for legal services rendered to Beckemeier personally rather than to the corporation.\(^{34}\)

In reversing, the court of appeals,\(^{35}\) speaking through then Judge Blackmun, first summarized the existing case law:

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\(^{30}\) *Farmers Union Corp. v. Commissioner*, 300 F.2d 197 (9th Cir.), *cert. denied*, 371 U.S. 861 (1962).


\(^{32}\) *Gravois Planing Mill Co., 29 P-H Tax Ct. Mem. 711, 717 (1960).*

\(^{33}\) *Id.*

\(^{34}\) *Id.*

\(^{35}\) *Gravois Planing Mill Co. v. Commissioner*, 299 F.2d 199 (8th Cir. 1962).*
Legal fees and other expenses of a partial liquidation may be deductible, within the statutory definition, as ordinary and necessary expenses paid in carrying on the business. . . . Where, however, a partial liquidation is accompanied by the corporation's recapitalization or reorganization, the transaction is to be viewed as a whole and its dominant aspect is to govern the tax character of the expenditures.38

The court went on to hold that the "dominant aspect" of the transaction at hand was partial liquidation rather than recapitalization.

[H]ere, as distinguished from the Second Circuit's conclusion in Mills Estate (with which we express no agreement or disagreement), the dominant aspect of the Gravois transaction was the liquidation of the Beckemeier shares and not the recapitalization. . . . Although there was, of course, a desire on the part of all to keep the organization going, the basic problem with which they struggled was that of the disposition of the outstanding Beckemeier stock and was not one directed to the change or any desired improvement in the form of the corporate structure. Stock retirement, that is, partial liquidation, was the problem and it was the essence of what transpired.37

Although the corporation's stated capital was reduced and article amendments were filed with the Secretary of State, the court saw this as a secondary rather than the dominant aspect of the transaction. Finally, the court found nothing in the record to justify a conclusion that any part of the legal expense was incurred for the benefit of Beckemeier personally.38

It may be significant that all of the cases discussed above were decided under the 1939 Code.39 Under section 115(i) of that Act, a partial liquidation was defined as a "distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock."40 Thus, under the 1939 Code, every redemption was a partial liquidation. Of course, not every redemption qualified for sale or exchange treatment for the shareholder involved. To receive such treatment, it had to be shown that the redemption distribution was not essentially equivalent to the distribution of a taxable dividend.41 Dividend nonequivalence could be demonstrated primarily in one of two ways. If the redemption was

38 Id. at 208 (emphasis added).
37 Id. at 209.
38 Id.
40 Id., ch. 1, § 115 (i), 53 Stat. 48.
41 Id. § 115 (g).
non pro rata, it would ordinarily qualify. Also, if the redemption resulted from a "corporate contraction" or legitimate shrinkage in the corporation's business activities, the shareholder whose shares were redeemed could qualify for sale or exchange treatment.

Thus, there were two types of partial liquidation of any moment: One involving a liquidation of some shareholder interest in the corporation; the other involving a liquidation of corporate business activities themselves.

Under the 1954 Code, the two types of transactions are separated so that section 302 covers non pro rata distributions and section 346 covers distributions resulting from contractions of the business enterprise. Only transactions falling under section 346 are termed "partial liquidations"; section 302 transactions are merely "redemptions." This split presented a temptation to permit a deduction for expenses of a section 346 transaction and to deny a deduction for expenses falling under section 302. Moreover, such treatment makes considerable sense. Since it is the corporation which is seeking the deduction, presumably one should be concerned with what is happening at the corporate level rather than effects at the shareholder level. More specifically, the analogy to a complete liquidation upon which the deduction is based is more apt in the case of a section 346 transaction than in the case of a section 302 redemption. Thus, with respect to both section 346 partial liquidations and section 331 complete liquidations, the Code contemplates that there will be corporate contraction and pro rata distribution. Further, the

42 See BITTKER & EUSTICE § 9.02; Treas. Reg. 118, § 39.11(g)-1(a) (2) (1953).
43 See BITTKER & EUSTICE § 9.02. Other factors were considered as well, the most important being whether there was a legitimate business purpose for the redemption. Id. However, in many of the earlier "business purpose" redemptions the factor of corporate contraction was present. United States v. Davis, 397 U.S. 301, 311-12 n.11 (1970).
45 The Senate Finance Committee in describing its action with respect to sections 302 and 346 stated:
  Your committee, as did the House bill, separates into their significant elements the kind of transactions now incoherently aggregated in the definition of a partial liquidation. Those distributions which may have capital-gain characteristics because they are not made pro rata among the various shareholders would be subjected, at the shareholder level, to the separate tests described in §§ 301 to 318. On the other hand, those distributions characterized by what happens solely at the corporate level by reason of the assets distributed would be included as within the concept of partial liquidation. S. REP. NO. 1622, 83d Cong., 2d Sess. 49 (1954).
46 It should be noted that while the "classic" section 346 transaction will be pro rata, this is not necessary to qualify under that action. See INT. REV. CODE OF 1954, §§ 346(b)-(c).
tax effects of both partial and complete liquidations are described in the same Code sections, and these tax effects are identical. Under section 336 no gain or loss is recognized by the corporation upon a distribution of property in "partial or complete liquidation," and under section 331 shareholders receive sale or exchange treatment for distributions in complete or partial liquidation. In short, the whole philosophy behind the treatment given to a section 346 partial liquidation appears to be that, for tax purposes, it should make little difference whether the contraction of a corporation takes place in whole or in part.\[47\]

On the other hand, a section 302 redemption resembles a complete liquidation merely in that corporate assets are being distributed to the shareholders. There is no contraction of the business in a section 302 transaction and the distribution is non pro rata. Further, in a section 302 transaction, because of the non pro rata nature of the distribution, there is a shifting of the interests of the shareholders — an element at least prima facie indicative of recapitalization.\[48\]

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\[47\] The extent to which the analogy between complete and partial liquidation actually applies to the expenses incurred in such transactions may depend upon the rationale for allowing deduction of expenses of complete liquidation in the first instance. If the rationale is that the corporation will no longer be in existence to enjoy the benefit of any kind of expense, the analogy is weakened by the fact that in a partial liquidation the corporation continues. On the other hand, if the rationale for allowing deduction of complete liquidation expenses is that these expenses are connected with the distribution of assets for which the corporation will have no further use, the analogy appears apt. That the latter view predominates is indicated by the following statement in Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962): "The theory most frequently advanced... is that expenditures of liquidation do not concern the creation or continuance of a capital asset." Id. at 206. Perhaps something can also be gleaned from the fact that, for an accrual basis taxpayer, expenses of complete liquidation are deductible in the year incurred rather than in the year of dissolution of the corporation. See, e.g., J. Gilmore Fletcher, 16 T.C. 273 (1951); Rite-way Prods., Inc., 12 T.C. 475 (1949), acquiesced in, 1949-2 Cum. Bull. 3. This fact would also indicate that the rationale for allowing the deduction is that the corporation has no further use for the assets, rather than that the corporation is terminating its existence.

By comparison, unamortized organizational expenses appear to be deductible (as a loss) only in the year of dissolution. See, e.g., Liquidating Co., 35 B.T.A. 1173, 1187-89 (1936), not acquiesced in, XV-2 Cum. Bull. 39 (1936), remanded pursuant to compromise offer, 3 CCH 1973 Stand. Fed. Tax Rep. § 2171.56 (9th Cir. 1937); Newport Co. v. United States, 34 F. Supp. 588 (E.D. Wis. 1940). But cf. Shellabarger Grain Pros. Co. v. Commissioner, 146 F.2d 177, 183 (7th Cir. 1944) (deduction allowed prior to actual dissolution where corporation had filed a statement of intent to dissolve with the secretary of state and had ceased all operations except those necessary to wind up its affairs). See generally Note, Income Tax Deductions on Corporate Termination, 9 Tax L. Rev. 490 (1954).

\[48\] Unfortunately, one is hampered in determining what constitutes a "recapitalization" by the absence of any judicial or legislative definition of that term beyond the broad definition contained in Helvering v. Southwest Consol. Corp., 315 U.S. 194, 202 (1942), i.e., a "reshuffling of a capital structure, within the framework of an
Unfortunately, allowing the deduction of expenses of section 346 transactions, while denying it for expenses connected with section 302 transactions, would not be in accord with many of the cases decided under the 1939 Code. Thus, in Mills Estate, Standard Linen, and Farmers Union there was corporate contraction, but the deduction was denied. To be sure in Standard Linen and Farmers Union there was a non pro rata distribution as well, thus infusing into the transactions elements of what today would be covered by both sec-

existing corporation." However, Treas. Reg. § 1.305-3(e), example (12) (1973), applies the term "recapitalization" to the following facts:

Corporation R has 2,000 shares of class A stock outstanding. Five shareholders own 300 shares each and five shareholders own 100 shares each. In preparation for the retirement of the five major shareholders, corporation R, in a single and isolated transaction, has a recapitalization in which each share of class A stock may be exchanged either for five shares of new class B nonconvertible preferred stock plus 0.4 share of new class C common stock, or for two shares of new class C common stock. As a result of the exchanges, each of the five major shareholders receives 1,500 shares of class B nonconvertible preferred stock and 120 shares of class C common stock. The remaining shareholders each receives 200 shares of class C common stock. See also Treas. Reg. § 1.368-2(e) (1)-(5) (1955) giving examples of a "recapitalization" under section 368(a) (1) (E).

While it is true that in each of these examples new securities are issued, the examples also seem to contemplate some shifting of shareholder or creditor interest. Notably, none of the examples so much as refer to whether the corporation's stated capital is changed (a factor apparently relied upon in the early partial liquidation cases as indicating a "recapitalization." See, e.g., Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953)). Thus where no new securities are issued, as is the case in the typical share redemption situation, it would appear to be more sound to rely upon a shifting of shareholder interest as indicative of a "recapitalization" than to rely upon a reduction of stated capital. Cf. Bass v. Commissioner, 129 F.2d 300 (1st Cir. 1942) (the lack of a change in stated capital was held to be indicative of a "recapitalization" (as opposed to a stock dividend)); Alan O. Hickok, 52 T.C. 80 (1959), not acquiesced in, 1959-2 CUM. BULL. 8. In Hickok, the corporation, in order to eliminate "dissident minority groups," embarked upon the following plan: Some of the minority stock was purchased by the majority group. Additional minority stock was purchased by the corporation for cash, and the balance was acquired by the corporation in exchange for 20-year, 6 percent debentures. The stock that had been purchased by the majority group was also acquired by the corporation in exchange for debentures. The Commissioner argued that there was no "continuity of interest" and hence no recapitalization-reorganization within section 112(g) (1) (E) of the Internal Revenue Code of 1939, ch. 1, 53 Stat. 40 (now INT. REV. CODE OF 1954, § 368(a) (1) (E)). The court held that the continuity of interest doctrine is not applicable to a recapitalization, stating:

A recapitalization of a single corporation often contemplates some change in interest, such as from stockholder to bondholder, and in a sense such a change might always be called an interruption of continuity. . . . It cannot be that the term "recapitalization" in the statute includes a requirement of the continuation of the old interest in proprietary form when recapitalization plans so often contemplate converting such interest to a nonproprietary form. 32 T.C. at 89-90. The court also said that there is no "requirement that a statutory reorganization by means of recapitalization must be one that strengthens the financial structure of the corporation." Id. at 93. But cf. Commissioner v. Estate of Bedford, 325 U.S. 283 (1945), where the Supreme Court stated that a reduction of capital brought into operation the predecessor of section 368(a) (1) (E).
tions 302 and 346. This, however, was not true in Mills Estate, the only court of appeals decision of the three. Of the two sections, Mills would come closer to falling under section 346 than section 302. Moreover, in Gravois, where the deduction was allowed by the Eighth Circuit, there was apparently no corporate contraction, only a non pro rata distribution. Thus, the case today would fall under section 302 and not section 346.

Nevertheless, there have been indications that the Internal Revenue Service and, to some extent, the courts are willing to allow a deduction for expenses connected with section 346 transactions and deny it for expenses of section 302 transactions. In Revenue Ruling 67-125, the Service considered whether legal fees for tax advice regarding: 

"(1) A merger, (2) a stock split, and (3) a proposed distribution in redemption of outstanding stock under section 302 of the Code (which distribution would not qualify as a partial liquidation under section 346 of the Code)" could be deducted under section 162. Citing, inter alia, Mills Estate and Standard Linen, the Service ruled that all of the fees represented capital expenditures. The implication of the parenthetical language, however, is that expenses of section 346 transactions might be treated otherwise.

Two recent cases in this line of decisions tend to support this view. In United States v. General Bancshares Corp., the taxpayer was a holding company governed by the Bank Holding Company Act of 1956. Pursuant to the requirements of that statute, the taxpayer sought to divest itself of its nonbanking assets by transferring them to a newly formed corporation in exchange for that corporation's stock, and then spinning off the stock pro rata to its shareholders. No stock was redeemed, although new shares evidencing a change in the taxpayer's name were issued in exchange for the old shares. The taxpayer incurred expenses related to documentary stamps, accounting services, printing costs of the new shares, transfer agent fees, and transfer taxes.

The district court, citing Gravois, held that the dominant aspect of the plan (excluding the change in corporate name) was liquida-

50 Id. at 32. The Service also ruled that if the stock redemption plan were abandoned, the capitalized legal fees attributable thereto could be deducted in the year of abandonment. Id. With regard to expenses of abandoned plans of stock offering, reorganization, etc., see Carruthers, supra note 8, at 1083.
tion and not reorganization. The court, therefore, allowed the deduction of all expenses except those relating to the name change. On appeal, the government argued that the plan did not meet the definition of a partial liquidation in section 346. Indeed, the government maintained, the taxpayer's plan substantially complied with the definition of a "D" reorganization in section 368(a)(1)(D). Alternatively, the government argued that if the transaction were viewed as a partial liquidation, its dominant aspect would be reorganization.

The court of appeals found that since section 346 is primarily concerned with the effect of the transaction on shareholders and not the corporation, it was of little value in determining the character of expenses incurred by the corporation. However, the court also said:

[T]he effect of the plan of divestment on the business operations of the taxpayer was the same as if its non-banking stocks were distributed via a cash dividend, a dividend in kind, a § 346 partial liquidation, or a distribution qualifying under §§ 1101-1103. Taxpayer suffered a contraction of corporate assets, having only assets in the banking field after the plan of divestment.

The court then held that the taxpayer was entitled to use the dominant aspect test of Gravois and that the dominant aspect of the distribution by the taxpayer was partial liquidation. Therefore, except for the expenses relating to the change in corporate name, the deduction was allowed.

The court's reference to contraction and the analogy drawn between the transaction in General Bancshares and a section 346 distribution seem to imply that a transaction that qualifies under section 346 would give rise to a deduction for the expenses involved. At least this would appear to be the case where, as in General Bancshares, the distribution is pro rata and thus contains none of the elements of a section 302 redemption.

54 388 F.2d at 189.
55 Id. at 190. It should be noted that Judge Blackmun, who wrote the opinion in Gravois, was on the panel in General Bancshares.
56 Id.
57 Compare Missouri-Kansas Pipe Line Co. v. Commissioner, 148 F.2d 460 (3d Cir. 1945), where the corporate taxpayer incurred expenses in distributing warrants to its shareholders to subscribe to stock of a corporation in which the taxpayer held a substantial minority interest. The warrants had been received by the taxpayer upon a recapitalization of the "subsidiary" corporation. The court denied the deduction on the ground that recapitalization expenses are not deductible, stating that if the "subsidiary" had distributed the warrants, it could not have deducted the expense, and that the taxpayer was in no better position.
The court in *General Bancshares* did not deal with the problem created by the fact that the transaction in *Gravois* itself did not involve any corporate contraction, and would not have qualified under section 346. Indeed, the court at one point said:

Thus, while *Gravois* . . . did involve a stock redemption plan meeting the formal requirements of a partial liquidation, the dominant aspect approach in characterizing expenditures incident to a distribution or liquidation of corporate assets vis-a-vis a concomitant corporate reorganization appears valid. This doctrine is not limited only to those expenditures incident to a distribution meeting the requirements of a § 346 partial liquidation.\(^5\)

Prior to the Eighth Circuit opinion in *General Bancshares*, a district court, in *Transamerica Corp. v. United States*,\(^5\) held deductible the expenses of a transaction essentially identical to that in *General Bancshares*. The court reasoned that the plan did not involve the creation of any tangible or intangible asset for the benefit of the corporation, and that, even assuming some change in the corporate structure had taken place, the "dominant purpose" of the liquidation was the distribution of assets (citing *Gravois*).\(^6\) On appeal, the Ninth Circuit affirmed, adopting the reasoning of the district court and citing as further reinforcement of its views the Eighth Circuit opinion in *General Bancshares*.\(^7\)

In summary, the earlier partial liquidation decisions\(^8\) seemed to base the deductibility of stock redemption expenses on whether the "dominant aspect"\(^9\) of the transaction was partial liquidation or recapitalization.\(^10\) These early cases were all decided under the

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\(^{53}\) 388 F.2d at 190-91.

\(^{59}\) 254 F. Supp. 504 (N.D. Cal. 1966), aff'd, 392 F.2d 522 (9th Cir. 1968).

\(^{60}\) Id. at 512-13.

\(^{61}\) United States v. Transamerica Corp., 392 F.2d 522, 523 (9th Cir. 1968).


\(^{63}\) As noted previously, some of the earlier cases employed a more restrictive test than "dominant aspect." See text accompanying notes 25-29 supra. The "dominant aspect" language first appeared in *Gravois Planing Mill Co. v. Commissioner*, 299 F.2d 199 (8th Cir. 1962), where it was used to characterize the earlier decisions. This characterization appears to have become generally accepted.

There were also two cases in the Tax Court which allowed the taxpayer to deduct half of the expenses. *Mills Estate, Inc.*, 17 T.C. 910 (1951), and *Tobacco Prod. Export Corp.*, 18 T.C. 1100 (1952), modified on other grounds, 21 T.C. 625 (1954), not acquiesced in, 1955-2 CUM. BULL. 11, appeal dismissed per stipulation, 4 P-H FED. TAXES § 71,121 (2d Cir. 1955). *Mills* was reversed by the Second Circuit, *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244 (2d Cir. 1953), and *Tobacco Products* was not followed thereafter. See notes 14-30 supra & accompany text.

\(^{64}\) The word "recapitalization" was first introduced in *Gravois Planing Mill Co.*, 29 P-H Tax Ct. Mem. 711, 717 (1960), rev'd, 299 F.2d 199, 208 (8th Cir. 1962),
1939 Code in which every redemption was a partial liquidation. Except for the Eighth Circuit decision in *Gravois*, the courts in these early cases seemed to place substantial emphasis on the formalities associated with carrying out the transaction. Apparently the formal reduction of stated capital was of special importance, and because of this emphasis, the dominant aspect of the transaction was in each case determined to be recapitalization.

In the cases arising under the 1954 Code, the authorities, though applying the same test as before, seemed to place more emphasis on the substance of the transaction. Of specific importance was whether the transaction resembled a section 346 contraction as opposed to a section 302 redemption. The apparent tendency was to allow a deduction for expenses of a section 346 transaction and to deny it for expenses of a section 302 type transaction.

**B. The Simple Acquisition Cases**

Alongside the partial liquidation line of decisions, a totally separate body of law has developed that treats the expenses incurred by a corporation in redeeming its own stock as expenses incurred in the simple acquisition of a capital asset. These cases apply the general rule that such expenses are to be capitalized as part of the cost of acquisition. Strangely, none of the cases in this line cite any of the partial liquidation cases, or even so much as mention partial liquidation, recapitalization, or reorganization. Moreover, none of the partial liquidation cases cite any of the simple acquisition cases.

The earliest authority in this line is *Office Decision 852*, where the Service ruled that expenses incurred by a corporation in purchasing its own stock "for the purpose of retirement or holding as where it was used by the Tax Court and adopted by the Eighth Circuit. The other cases referred variously to "reorganization," e.g., *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953), or a "change in the corporate structure for the benefit of future operations," e.g., *Farmers Union Corp.*, 29 P-H Tax Ct. Mem. 1039, 1054 (1960), aff'd, 300 F.2d 197 (9th Cir.), cert. denied, 371 U.S. 861 (1962). However, the term "recapitalization" appears to accurately reflect what was meant. See *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942), defining "recapitalization" as a "reshuffling of a capital structure, within the framework of an existing corporation." See note 48 *supra*.


66 Indeed, few of the cases in the simple acquisition "line" cite anything, not even earlier cases in the same line. And none of them cite *Office Decision 852*, 4 CUM. BULL. 286 (1921), which was the first authority to stand for the proposition.

67 4 CUM. BULL. 286 (1921).
treasury stock" were "to be considered part of the purchase price of the stock." To the same effect, Southern Engineering & Metal Products Corp.\textsuperscript{68} denied a deduction for legal and accounting fees connected with the redemption of the stock of a 50-percent shareholder. The court stated simply that the fees "should have been treated as a capital expenditure, \textit{i.e.}, as part of the cost of the stock."\textsuperscript{69}

It should be noted that in several of the simple acquisition cases the taxpayers contended that the redemption was necessary in order to settle inter-shareholder strife. Moreover, in some cases there was evidence that, but for the redemption, damage would have been done to the corporation itself. For example, in Commerce Photo Print Corp.,\textsuperscript{70} the taxpayer contended that the primary purpose of the redemption of the stock held by its secretary-treasurer was to prevent him from further implementing price-cutting policies which were causing losses to the corporation.\textsuperscript{71} Indeed, the court specifically found that a recent loss sustained by the corporation was due in part to these policies.\textsuperscript{72} Yet the court held that the majority shareholder's desire to eliminate the secretary-treasurer from the business was immaterial. The court then said the "fee which was paid in connection with petitioner's acquisition of 49 percent of its own shares in exchange for the stock of its subsidiary corporation was an expenditure for the acquisition of property; and, therefore, a capital expenditure rather than a business expense."\textsuperscript{73}

Similarly, in Atzingen-Whitehouse Dairy, Inc.,\textsuperscript{74} there were three equal shareholders, Walter and William Von Atzingen and Henry Zima. Friction arose between the Von Atzingens and Zima, and it was decided that the corporation should redeem the shares held by the Von Atzingens. The Tax Court denied the corporation a deduction for the $6,000 legal fee incurred in connection with the transaction. Judge Raum said:

\begin{quote}
That payment is a capital expenditure which should have been treated as part of the cost of the stock purchased. It is not deductible as an ordinary and necessary business expense. The fact that the purchase of the stock was motivated by a desire to elim-
\end{quote}

\textsuperscript{68} 19 P-H Tax Cr. Mem. 81 (1950).
\textsuperscript{69} Id. at 84.
\textsuperscript{70} 16 P-H Tax Cr. Mem. 334 (1947), appeal dismissed, 3 P-H FED. TAX SERVICE CITATOR 5712 (2d Cir. 1947).
\textsuperscript{71} Id. at 339.
\textsuperscript{72} Id. at 338.
\textsuperscript{73} Id. at 340.
\textsuperscript{74} 36 T.C. 173 (1961).
inate friction between the Von Atzingens and Zima is immaterial. Certainly, the cost of the stock itself was a capital expenditure rather than a deductible expense, and the accompanying legal fee must similarly be classified.75

*Commerce Photo Print* was not cited, nor were any other authorities.

*Annabelle Candy Co.*76 was decided after *Atzingen* and involved similar facts. After difficulties had arisen between the corporation’s two 50-percent shareholders, the corporation bought out the interest of one of them. The corporation argued that a portion of the attorney’s services was devoted to avoidance of dissolution and to devising alternative plans discussed prior to the adoption of the redemption agreement. The court held that the entire expenditure was related to the agreement to purchase the stock and should be treated as part of its cost.77 However, the court went on to say that, had the petitioner proved that other services (*i.e.*, avoiding dissolution) were actually rendered, an allocation of the total legal fee between the deductible and nondeductible portions might have been possible.78

It is difficult to understand why the partial liquidation and the simple acquisition lines of authority developed as they did.79 In

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75 Id. at 183.
76 30 P-H Tax Cr. Mem. 953 (1961), remanded on other grounds, 314 F.2d 1 (9th Cir. 1962).
77 Id. at 957.
78 Id.
79 Perhaps something can be learned from the chronology of the decisions set forth in Appendix A infra. Since *Commerce Photo-Print* and *Southern Engineering*, both simple acquisition cases, were decided prior to any of the partial liquidation cases, it is not surprising that they did not mention partial liquidation. However, the subsequent six decisions were all partial liquidation cases, and the failure of the courts in those cases to cite *Commerce Photo-Print* and *Southern Engineering* is less understandable. Indeed, the transaction in *Standard Linen* (non pro rata distribution of the assets of a former subsidiary operating a related business) bears striking resemblance to the transaction in *Commerce Photo-Print* (non pro rata distribution of the stock of a subsidiary itself, also operating a related business). Further, the transaction in *Gravois* was similar to that in *Southern Engineering* (non pro rata distribution of cash). The next two cases, *Atzingen* and *Annabelle Candy*, were simple acquisition cases, but their failure to cite the previous partial liquidation cases might be explained on the ground that *Atzingen* and *Annabelle Candy* were both decided under the 1954 Code in which a simple cash redemption with no corporate contraction (the type of transaction involved in both cases) was no longer described as a partial liquidation. The rest of the cases were all partial liquidation cases, and again it is hard to understand why these courts did not cite any of the simple acquisition cases. This is especially true with respect to the court of appeals decision in *Gravois*, where the transaction was similar to that in *Atzingen*. Thus, on balance, it appears that the failure of the simple acquisition cases to cite the partial liquidation cases is more understandable than the failure of the partial liquidation cases to cite the simple acquisition cases.

The only explanation that comes to mind for the failure of the partial liquidation cases to cite the simple acquisition cases is that in all of the partial liquidation cases
any event, it should be noted that, as in the early partial liquidation rulings, both Commerce Photo Print and Southern Engineering were decided under the 1939 Code.\textsuperscript{80} Under that Act it was possible for a corporation to recognize gain or loss upon the resale of its treasury stock, that is, when it dealt in its own shares as it might in the shares of another corporation.\textsuperscript{81} Thus, it is perhaps not too surprising that the early simple acquisition cases held that the expenses of purchase were to be added to the cost of the shares, under the general rule that expenses of purchase of a capital asset are to be added to the basis of the asset. In fact, the court in Commerce Photo Print noted that the corporation had entered the repurchased shares on its books as treasury stock\textsuperscript{82} and was holding them for subsequent sale to its officers. Such a resale to employees, used as an incentive device, was viewed by some courts as the type of transaction in which the corporation was dealing in its own shares just as it might in the shares of another corporation.\textsuperscript{83}

The 1954 Code, however, provides in section 1032: “No gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation.” And the regulations under this section state that it applies even though the corporation deals in its own shares as it might in the shares of another corporation.\textsuperscript{84} Thus, after 1954, a corporation’s basis in its own repurchased shares is irrelevant. Adding the cost of the redemption transaction to the basis of the stock might then seem unfair, since this would mean that such costs would never be deductible.\textsuperscript{85} Further, section 1032 appears to recognize that a corporation’s own repurchased stock is not an asset to the corporation any more than its own authorized

\textsuperscript{81} Treas. Reg. 118, § 39.22(a)-15(b) (1953). On the other hand the original issuance of shares resulted in no taxable income. Id.
\textsuperscript{82} 16 P-H Tax Cr. Mem. at 339.
\textsuperscript{83} See BITTKER & EUSTICE § 3.13. Other courts construed the regulation more narrowly. Id.
\textsuperscript{84} Treas. Reg. § 1.1032-1(a) (1956).
\textsuperscript{85} See D. HERWITZ, supra note 8, at 545.
but unissued shares. Consequently, there is a significant conceptual problem in requiring that the redemption expenses be treated as part of the cost of an "asset" acquired. It might have been expected, therefore, that, after the 1954 Code was adopted, the courts in the simple acquisition cases would have taken into account the lack-of-asset-lack-of-basis problem in deciding whether to require capitalization of redemption expenses. However, two of the simple acquisition cases discussed above, Atzingen and Annabelle Candy, were decided under the 1954 Code and no mention was made of section 1032 or the ultimate nondeductibility of the expenses.

Interestingly, there has been one case in which this factor was considered sufficiently important to allow the taxpayer to deduct the expense. In T. Jack Foster, two affiliated corporations paid legal fees in the process of obtaining FHA approval to redeem their Class A stock, which was held by a single parent corporation. In allowing the deduction the Tax Court emphasized the fact that the redeemed stock was cancelled and therefore "no 'treasury stock' [was] acquired by the corporation to add this expense to as a basis." The court concluded:

We agree with respondent that the item is of the nature of selling expenses in connection with the sale of stock. Ordinarily, this would be considered as increasing the amount paid for the stock and would become a part of the cost and basis of an asset acquired. In the instant case, Ord and Monterey [the two affiliated corporations] redeemed their stock and so had no asset, the basis of which could be increased. Under these circumstances the amount is in the nature of an amount expended in an effort to acquire a capital asset which results in a failure to acquire the asset. On this analogy we conclude that petitioners are entitled to deduct the $2,700 payment.

It should be noted that this "basis irrelevancy" argument, is not without its difficulties. For example, conceptually, if the expenses

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86 Today, of course, it is almost universally recognized that stock should not be viewed as an asset in the hands of the issuer. Once reacquired such "treasury" stock is no different from authorized but unissued stock, which has never been accorded asset status. And insofar as creditors are concerned, they usually become worried about the makeup of the assets of a corporation as a source for payment of their claims only when they are not being paid in ordinary course, and at such times treasury stock is almost certain to be worthless.

Herwitz, supra note 5, at 305-06.


88 Id. at 1589.

89 Id.
of redeeming the stock are thought of as part of the cost of the shares, they should be no more deductible than the actual redemption payment itself. In other words, the rationale of the 1954 Code simple acquisition cases (Atzingen and Annabelle Candy) may not be that the expenses are connected with the acquisition of an asset, but rather that the expenses are connected with the distribution in exchange for the stock, and that they therefore increase that distribution. In this regard, it should be noted that all the simple acquisition cases only in Commerce Photo Print, a 1939 Code case, is there any specific asset acquisition language. And, as mentioned previously, in that case the stock acquired might have had some asset significance to the corporation.90 The other simple acquisition cases, including Atzingen and Annabelle Candy, all speak of the expenses as being simply part of the "cost" of the stock. Perhaps the word "cost" in this context is a reference to asset distribution rather than asset acquisition.

In Foster the government apparently attempted an argument along these lines when it urged that the item in question was in the "nature of selling expenses in connection with the sale of stock." Such stock issuance expenses are regarded as merely reducing the net proceeds received by the corporation for its stock.91 They are therefore not deductible either currently or as a section 165 loss upon dissolution of the enterprise.92 Arguably, by analogy, stock redemption expenses should be regarded as increasing the amount of the distribution and should also not be deductible.

The difficulty with this analysis is that if stock redemption expenses are thought of as connected with the distribution of assets, there are closer analogies to be drawn than the one to stock issuance expenses. Thus, it appears that expenses of a simple cash or property dividend are deductible.93 If this is so, then expenses of

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90 See note 83 supra & accompanying text.
91 Bittker & Eustice § 5.04.
92 Id. But see Weissman, supra note 8, at 718 and cases discussed therein. Expenses of stock issuance, such as commissions, professional fees and printing costs, are not amortizable under section 248 either. Treas. Reg. § 1.248-1(b) (3) (i) (1956). Interestingly, the expenses of drafting the terms of original stock certificates are amortizable under section 248. Treas. Reg. § 1.248-1(b) (2) (1956). But this, of course, is pursuant to specific statutory authority, without which no deduction would be allowed. See Bittker & Eustice § 5.07.
93 See text accompanying note 56 supra, where the court in United States v. General Bancshares Corp., 388 F.2d 184 (8th Cir. 1968), implies that such expenses would be deductible.
See Transamerica Corp. v. United States, 254 F. Supp. 504, 511 (N.D. Cal. 1966),
a distribution in exchange for stock should also be deductible. Given this analogy, it may be assumed that it is only the presence of the stock that differentiates the simple acquisition cases (including *Atzingen* and *Annabelle Candy*) and leads to a denial of the deduction. This in turn indicates that the rationale of all of these cases is asset acquisition after all, which is further supported by the fact that the word "cost" generally connotes asset acquisition rather than asset distribution.

The fact remains, however, that, at least under the 1954 Code, a corporation's repurchased stock is no more an asset to the corporation than its own authorized but unissued shares. Certainly, the courts in the 1954 Code simple acquisition cases were aware of that fact. To be sure the expenses connected with creating authorized but unissued shares would not be deductible but for section 248. But this is because they are *organization* expenses, not because they are expenses of acquiring a capital asset.

Perhaps this latter fact may yield a clue as to the rationale of the 1954 Code simple acquisition cases. In every simple acquisition case (including the 1954 Code cases) there was a non pro rata distribution. In other words, there was a shifting of the interest of the shareholders. Thus, perhaps the courts, at least in the 1954 Code simple acquisition cases, detected elements of recapitalization in the transactions before them, and disallowed the expenses on that basis. If so the later simple acquisition cases are consistent with the more recent partial liquidation authorities which seemed to favor deductibility for expenses of a section 346 transaction, but to deny it for expenses of a section 302 redemption. Indeed, even *T. Jack Foster* might be explained along these lines, for in that case the redeemed stock was held by the parent of the taxpayer corporations, and the parent continued to own the remainder of the subsidiaries' stock after the redemption. Thus, in *Foster*, while there was no corporate contraction, there was at least no shifting of the interest of any of the shareholders. In short, the recent simple

*aff'd*, 392 F.2d 522 (9th Cir. 1968), where the deductibility of cash or property dividend expenses is assumed without discussion. Cf. Rev. Rul. 69-615, 1969-2 CUM. BULL. 26 (fees paid to registrar and transfer agent for maintenance of stock records, not related to an original issue of stock, merger, consolidation or stock dividends are ordinary and necessary business expenses).

94 See note 86 *supra*.

95 As used in the text the category "simple acquisition cases" does not include *T. Jack Foster*, where the deduction was allowed. See text accompanying note 87 *supra*.

96 See note 65 *supra* & accompanying text.
acquisition cases may, at least on a factual basis, be reconciled with the recent partial liquidation authorities.\footnote{An interesting recent development in the simple acquisition line of authority lies in the supersedure of Office Decision 852, 4 CUM. BULL. 286 (1921), by Rev. Rul. 69-561, 1969-2 CUM. BULL. 25. As mentioned above, in O.D. 852 the Service ruled that "expenses" of stock repurchase were to be considered part of the purchase price of the stock. However, in Revenue Ruling 69-561, the Service stated merely that "brokerage fees" incurred by a corporation in purchasing its own stock are "part of the purchase price of the stock so acquired." The Service's reference to "brokerage fees" as opposed to "expenses" may indicate some retreat from its original position. Brokerage fees are usually incurred only where the shares of a publicly held corporation are purchased in the open market. This type of transaction usually does not involve the type of expenses with which most of the simple acquisition cases have been concerned, i.e., legal and accounting fees incurred by a closely held corporation in redeeming its stock. Thus, perhaps, the Service is restricting the simple acquisition rule to routine trading by a publicly held corporation in its own shares.

On the other hand, the revenue ruling cites Atzingen-Whitehouse Dairy, Inc., 36 T.C. 173 (1961), to support its position, and that simple acquisition case involved the purchase by a closely held corporation of the stock held by two of its three equal shareholders. The expenses were legal and accounting fees, not brokerage fees. Furthermore, the reference to brokerage fees in the revenue ruling may be merely an attempt to bring the ruling in line with the regulations under section 263, which, in dealing with the general question of expenses to be added to the cost of securities, refer only to "commissions." Treas. Reg. § 1.263(a)-2(e) (1958).}

C. The Business Purpose Cases

Surprisingly, there is yet a third set of cases dealing with stock redemption expenses. Under these cases, the expenses incurred by a corporation in redeeming its own stock are deductible if the redemption was necessary to achieve a legitimate corporate business purpose, such as avoiding liquidation. Indeed, the Fifth Circuit has gone so far as to hold that, in such circumstances, the purchase price of the stock itself is deductible.

In *Five Star Manufacturing Co. v. Commissioner*,\footnote{355 F.2d 724 (5th Cir. 1966), rev'd 40 T.C. 379 (1963).} the corporation, owned in equal parts by Smith and Kincade, was the assignee of a patent licensing agreement. When the corporation stopped paying royalties, the owner of the patent, Freeman, sued and recovered a money judgment as well as cancellation of the licensing agreement. Freeman then entered into a new licensing agreement with Kincade. Freeman was unwilling to have Smith take part in the transaction since Smith's heavy drawings from the corporation apparently had been the cause of the original breakdown in the flow of royalties. Thereafter, the corporation sued Smith to recover the draws. Smith countered with a suit to have the corporation
placed in receivership. The court refused to grant receivership and awarded the corporation a judgment against Smith. The court also ordered public sale of Smith's stock to satisfy the judgment. The corporation was the only bidder, and, after some controversy over the price, the sale was ultimately confirmed. The corporation attempted to deduct the purchase price of the stock.

The Tax Court held that the payment was not deductible since "any benefit resulting from the purchase of the stock would extend over an indefinite number of years." However, the court of appeals reversed. Judge Jones reasoned:

At the time of the judicial sale of the Smith stock, two-thirds of the Finished Goods Inventory was under the attachment made at the behest of Freeman. The license to manufacture and sell under the Freeman patent had been cancelled. Five Star had neither the right to sell nor goods which could have been sold. It had no working capital and no credit. It had obligations which could not have been paid from the assets upon liquidation which would have been inevitable if Smith had not been removed from the scene. As intimated by the district court, the future of the company, at the time of the sale, depended upon Kincade, his credit, his know-how, energy and business ability. It also depended upon Freeman's willingness to allow Five Star to continue in business under Kincade's management and backing but only if Smith was out of the picture. Had Smith remained as the owner of fifty percent of the stock of Five Star, its liquidation was inevitable, and in the event of its liquidation there could have been no realization for stockholders. With the removal of Smith, with the management and credit of Kincade, and with the cooperation of Freeman, there was a chance for survival.

It can scarcely be held that the payment to Smith was for the acquisition of a capital asset, but rather one which would permit Five Star again to use assets for income production by freeing its management from unwarranted fetters.

The court then upheld the deduction, citing cases holding that the purchase of stock by a taxpayer to assure a supply of goods could give rise to a deductible loss.

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100 Id. at 391.
101 355 F.2d 724 (5th Cir. 1966).
102 Id. at 727.
103 Id. See also Williams & Waddell, Inc. v. Pitts, 148 F. Supp. 778 (E.D.S.C. 1957). There the taxpayer was an insurance agency. One of its two equal shareholders died and his widow inherited his stock. The companies for which the corporation acted as agent refused to accept the widow's designee as a substitute for her deceased husband. To induce her to sell her shares to someone acceptable to the companies, the corporation promised to pay her $100 per month for life, the amount to be increased depending on the earnings of the corporation. These payments by the
General Pencil Co., a business purpose case decided several years before Five Star, did not go quite as far; it held that the business purpose of a redemption justified the deductibility of the expenses connected with the transaction. In General Pencil, one-third of the corporation's stock was owned by Raymond Weissenborn. His brother, Oscar, and a brother-in-law owned the other two-thirds. The corporation was losing money, and the board of directors advised Raymond, the company's president, "of the functions he should perform and how he should carry on his work." Raymond promptly resigned. Thereafter he threatened the corporation with suit for receivership. Several of the corporation's salesmen resigned because of the internal situation, and some of the corporation's best customers expressed concern. The corporation then employed legal counsel and negotiations with Raymond went on for several months, but no settlement was reached. The corporation then employed new counsel who, after further negotiations, advised the company that "the only way open to a satisfactory settlement with Raymond was for [the corporation] to buy his stock in the company." The corporation then "reluctantly made the purchase."

In upholding the deduction for the $1,700 of legal expenses involved, the court said:

It was necessary to employ counsel to protect petitioner's business interests against the threat of a possible receivership, and to cope with the other disrupting forces let loose by Raymond Weissenborn which had brought about the temporary resignation of certain key salesmen and brought from customers inquiries as to what was taking place in the affairs of the petitioner. The fact that the dispute was finally settled by the purchase by petitioner of the shares held in it by Raymond Weissenborn does not establish that the attorneys' fees were paid as an incident to the acquisition of such shares. Nor do we think the fees can be said to constitute "the cost of defending or perfecting title to property," within the meaning of the Commissioner's Regulations. The regulation referred to was Treas. Reg. 103, § 19.24-2 (1942). See also William C. Atwater & Co., 10 T.C. 218 (1948), acquiesced in, 1948-1 P-H Tax Ct. Mem. at 689.

105 Apparently, the taxpayer did not contend that the purchase price itself was deductible.
107 Id.
109 Id.
Notwithstanding the contrary protestations of the court, it seems clear that at least part of the expenses in General Pencil were incurred in fixing the terms of the purchase agreement. Thus, the case seems factually similar to Annabelle Candy in the simple acquisition line. There the taxpayer urged that a portion of the attorney's services was devoted to avoidance of dissolution, and to devising alternative plans discussed prior to the adoption of the redemption plan. And, while the court in Annabelle Candy expressed some willingness to allocate the fee in question, it implied that under no circumstances would the portion attributable to the redemption itself be deductible.\textsuperscript{9}

Again, neither of the two business purpose cases discussed above cited any of the partial liquidation or simple acquisition cases. Nor did any cases in those lines of authority mention the business purpose cases.\textsuperscript{10}

Although the business purpose cases number the fewest of the three lines of authority; there is much to be said for the approach they adopt. Except for the later partial liquidation cases, only in the business purpose line is any express attention paid to the substance of the transaction as opposed to the formalities of carrying it out. Thus, as noted previously, the early partial liquidation cases (except Gravois) seemed to stress the factor of stated capital reduction as indicative of recapitalization.\textsuperscript{11} Reduction of capital seems to be a rather perfunctory act and a meaningless touchstone for capitalization. Indeed in Mills Estate, the earliest case in the partial liquidation line, reduction of capital was required by state statute.\textsuperscript{12} In the simple acquisition cases, while the courts may have

\textsuperscript{9} See text accompanying note 78 supra.

\textsuperscript{10} General Pencil Co., 13 P-H Tax Ct. Mem. 689 (1944), was decided before any of the simple acquisition or partial liquidation authorities except Office Decision 852, 4 CUM. BULL. 286 (1921) (simple acquisition). Five Star Mfg. Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), was decided after several partial liquidation and simple acquisition cases.

\textsuperscript{11} See notes 62-65 supra & accompanying text.

\textsuperscript{12} See note 15 supra.
been considering factors other than whether a "capital asset" was involved, this could hardly be determined from the language used. And, except for Foster, no express attention was paid to the fact that treasury stock has no real asset significance for a corporation, at least not under the 1954 Code.

To be sure, a business purpose approach is not without its difficulties, the principal one being whether the business purpose involved is capital or noncapital in nature. Thus, in Five Star the Tax Court and the court of appeals differed on the question of whether the stock purchase was of long-term benefit to the corporation. This was probably due to the fact that there were a number of business purposes involved in Five Star: there was the simple desire to avoid liquidation, the desire to protect the licensing agreement, and, finally, the desire to eliminate shareholder friction over matters of corporate policy.

Nonetheless, when the question arises of whether a business purpose is capital or noncapital in nature, the courts are not without analogies upon which they can draw. For example, avoiding liquidation in a nonredemption context has been held to give rise to a deduction for the expenses involved. And, as noted in the court of appeals decision in Five Star, the purchase of another corporation's stock for the purpose of obtaining a source of supply has been held to give rise to an ordinary loss deduction.

Perhaps most appropriate in connection with redemption situations is the analogy to proxy-fight expenses. It seems fairly well established that reimbursements to shareholders for proxy-fight expenditures are deductible by the corporation, provided that "such expenditures were primarily concerned with a question of corporate policy." In the context of a closely held corporation, contests

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113 See text accompanying notes 99-102 supra.

114 See Western Grain Co. v. Patterson, 59-2 U.S. Tax. Cas. 73,466 (N.D. Ala. 1959).


over corporate policy can often be settled only by share redemption. This may be true in some cases of publicly held corporations as well. It seems inconsistent to allow deductibility for expenses of one method of resolving questions of corporate policy while denying deductibility for expenses of another method.  

Of course, not all of the analogies will tend toward deductibility for stock redemption expenses. Thus, in *Five Star* there was protection of a licensing agreement as a result of the stock repurchase. It has been held that payments to protect a franchise are not deductible and the same is generally true of other payments involved in the elimination of competition.  

Perhaps, where, as in *Five Star*, there are several purposes, some capital and others noncapital, it would not be inappropriate to make some sort of allocation of the expenses. Further, some of the expenditures might be allocable to, or create, a capital asset of limited duration, thus, giving rise to later deductions for amortization.  

Finally, some observations are in order as to the relationship of the business purpose cases to the other two lines of authority. First, it should be noted that both of the business purpose cases involved non pro rata redemptions and do not fit under the rubric previously suggested for reconciling the recent simple acquisition and partial liquidation cases. Nonetheless, it may be significant that in the business purpose cases, the business purpose involved was of major proportions, while, in most of the simple acquisition cases in which a business purpose was suggested, that purpose appeared to be of lesser importance. The only exception in the simple acquisition line was *Commerce Photo Print*, where there was a specific finding that the shareholder whose stock had been redeemed was causing losses to the corporation. There, however, the stock was held for resale to employees and, under the 1939 Code, might have had some asset significance to the corporation. In other words, the asset significance of the stock might have been a factor which overshadowed the strong business purpose in *Commerce Photo Print*. In the other simple acquisition cases either there was a failure to

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117 Moreover, where it can be shown that a particular shareholder has actually caused losses to the corporation, the corporation's case should be stronger still.  
120 See text accompanying notes 95-97 supra.  
121 See notes 82-83 supra & accompanying text.
show any business purpose or the business purpose was of lesser significance than that involved in the business purpose cases. Thus, in *Atzingen* and *Annabelle Candy*, the two 1954 Code simple acquisition cases, there was only the suggestion of shareholder friction, but these cases did not involve compelling factual situations such as those in *Five Star* and *General Pencil*.

Perhaps, then, the business purpose cases may be reconciled with at least the more recent simple acquisition cases on the theory that presumptively a section 302 redemption does not give rise to a deduction for the expense involved, but where a showing of a strong noncapital business purpose is made, the presumption is overcome.

III. Appraisal Expenses — The *Woodward* and *Hilton* Decisions

A. The Background

Most corporate statutes provide that when a shareholder dissents from some major corporate action, he is entitled to have his shares appraised and to receive the fair market value of those shares. From a tax standpoint such appraisal proceedings may be viewed in several ways:

1. First, the appraisal proceedings may be pursuant to a statutory merger or consolidation, with one corporation substantially larger than the other, and with the dissenters holding stock in the smaller corporation. Under most corporate statutes appraisal is referred to as "the payment for . . . shares." Moreover, it is usually the surviving or new corporation which bears the liability. Therefore, under the facts set forth above, it is possible to characterize the appraisal proceedings as the purchase by the larger corporation of the stock held by some of the shareholders of the smaller corporation.

2. On the other hand, appraisal rights for dissenting shareholders arise in the context of a vote by the shareholders of a particular corporation. This is true whether a merger or other corporate action (such as a sale of assets) is involved. Thus, it is pos-

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122 See, e.g., MBCA § 80.
123 MBCA § 81. See MBCA § 6: "[A] corporation may purchase or otherwise acquire its own shares for the purpose of: . . . (C) Paying dissenting shareholders entitled to payment for their shares under the provisions of this Act." (emphasis added).
124 See, e.g., MBCA § 81.
125 See, e.g., MBCA §§ 72-73, 79-80.
sible to characterize appraisal proceedings as being incident to the purchase by the dissenters' corporation of its own shares. Under this view, the fact that in a merger the legal obligation is that of the surviving corporation might be explained on the ground that the surviving corporation is responsible for the obligations of its predecessors by operation of law.\textsuperscript{126}

3. On a broader level, where a merger or consolidation is involved, it is possible to view appraisal proceedings as being simply incident to the primary transaction, \textit{i.e.}, the merger or consolidation.

4. Finally, it could be argued that appraisal proceedings are incident neither to the purchase of shares nor to merger, consolidation, or other corporate action. With regard to the share purchase aspect of the transaction, it should be noted that under many corporate statutes most incidents of share ownership cease to exist for the dissenters upon their demand for appraisal.\textsuperscript{127} Thus, the ensuing proceedings do not involve title to the shares, only the value of the shares. Insofar as a merger is concerned, it could be argued that appraisal does nothing to further the merger. Indeed, the merger proceeds in spite of, rather than because of, the appraisal. In other words, appraisal, in some sense, is at odds with the "restructuring" which is the ongoing attribute of a reorganization. Viewed in this light, the expenses of appraisal appear incident to answering the claims of uncooperative owners. Such expenses are, of course, "occasioned" by the reorganization, but do little to "further it."

It should be noted that, of these four views of an appraisal proceeding, only the last would clearly lead to a deduction for the expenses involved. Expenses involved in the purchase by one corporation of the stock of another (#1 above) are generally not deductible under well established principles;\textsuperscript{128} nor are expenses of reorganization (#3 above). The determination of the deductibility of expenses incurred by a corporation in purchasing its own stock (#2 above) throws one into the maze of case law described earlier. Thus, only by viewing appraisal proceedings as incident neither to stock purchase nor to reorganization, can the expenses be characterized as noncapital in nature. It is not surprising, therefore, that

\textsuperscript{126} See, \textit{e.g.}, MBCA § 76(e).


\textsuperscript{128} See, \textit{e.g.}, Fireman's Ins. Co., 30 B.T.A. 1004 (1934).
corporate taxpayers wishing to deduct appraisal litigation expenses have attempted to paint this picture of appraisal proceedings.

The first such attempt was unsuccessful. In *Boulder Building Corp. v. United States*, a majority of the corporation's shareholders voted to extend the then expiring corporate charter and to amend the powers of the corporation. Under Oklahoma law this action gave rise to appraisal rights for dissenting shareholders. During the ensuing appraisal litigation the corporation paid approximately $28,000 in legal and appraisal fees.

The district court, in holding that the fees had to be capitalized, said:

> [T]he decisions have uniformly held that where professional fees are paid in connection with the acquisition of stock, or where the title to stock is defended or perfected, such expense whether for attorney's fees, or otherwise, cannot be deemed an ordinary business expense but must be classified as a capital expenditure, an expenditure to be taken into consideration in determining capital gain or loss at the subsequent sale of the involved stock."\(^1\)

The court went on to hold that "'[t]he expenditures associated with the ultimate transfer of approximately one-third of the plaintiff's corporate stock cannot be deemed an expense arising out of ordinary business operation but must be considered an expenditure directly related to the acquisition of capital stock.'"\(^2\)

It should be noted that only one corporation was involved in *Boulder Building*. Thus, the court could not have considered this transaction as the purchase by one corporation of the stock of another. Nor could the transaction have been viewed as a reorganization, *i.e.*, a merger or consolidation. In view of the nondeductibility holding, then, the court must have viewed the transaction as the purchase by a corporation of its own stock. Therefore, the case could easily be classified as just another simple acquisition case.\(^3\)

Like the other simple acquisition cases, no reference was made in *Boulder* to any of the partial liquidation or business purpose cases. However, none of the simple acquisition cases were cited either.

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2. *Id.* at 515.
3. *Id.* at 516-17. The court did not discuss whether, under Oklahoma law, title to the stock remained in the dissenting shareholders until the value of the stock had been determined. However, this appears to have been the case. OKLA. STAT. ANN. tit. 18, § 1.161 (1951).
4. Since there was a non pro rata distribution, the result in *Boulder* is consistent with the rationale suggested for reconciling the simple acquisition cases with the later partial liquidation cases. See text accompanying notes 95-97 supra.
The next case of appraisal litigation expenses incurred by a corporation resulted in success for the taxpayer. In *Smith Hotel Enterprises, Inc. v. Nelson*, two of three shareholders voted in favor of the sale of substantially all of the corporation's assets. Under Wisconsin law, such action gave rise to appraisal rights for the dissenter. In allowing the corporation to deduct the expenses incurred, the court said:

Counsel for the plaintiff urges that the decision in *Boulder* is unsound in that it disregards the fact that the taxpayer's obligation to purchase the dissenters' stock was an involuntary obligation. Under the Oklahoma statute, as well as under the Wisconsin statute, once the dissenters have demanded that the corporation purchase their shares at fair value, the corporation has no choice in the matter. After the demand has been made, the corporation's main concern is with keeping its liability to a minimum. Plaintiff's argument is sound. Viewed in this light it appears that the primary purpose of the state litigation in the instant case was a determination of the fair value of the shares, and the involvement of title was incidental. The deduction made by the taxpayer was proper as an ordinary and necessary business expense.

Again, as in *Boulder*, only one corporation was involved in *Smith*. Thus, there was no possibility for the government to argue that the expenses were reorganization expenses or to argue that they were incident to the purchase by one corporation of the stock of another. Here, then, it is clear that the fourth view of the transaction was accepted.

It should also be noted that there is at least a surface similarity between the primary purpose test employed by the court in *Smith Hotel* and the approach taken by the business purpose cases

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139 Id. at 306.

135 See also Vermont Bank & Trust Co. v. United States, 296 F. Supp. 682 (D. Vt. 1969), discussed at note 178 infra. In addition to these cases, stock appraisal expenses had, prior to the decisions in Woodward v. Commissioner, 397 U.S. 572 (1970), and United States v. Hilton Hotels Corp., 397 U.S. 580 (1970), given rise to two cases dealing with the other side of the coin, namely the deductibility under section 212 of the expenses of the individual whose stock is appraised. In Walter S. Heller, 2 T.C. 371 (1943), aff'd, 147 F.2d 376 (9th Cir.), cert. denied, 325 U.S. 868 (1945), the Tax Court ruled that the expenses were deductible (rather than simply reducing the net proceeds of the transaction) on the ground that the expenses "bore a reasonable and proximate relation to the production or collection of income, and to the management of property held for that purpose." Id. at 374. *Heller* was followed on similar facts in Stempfel v. United States, 69-1 U.S. Tax Cas. 84,081 (M.D. Tenn. 1969), as well as in Woodward, 49 T.C. 377 (1968), aff'd, 410 F.2d 313 (8th Cir. 1969), aff'd, 397 U.S. 572 (1970). After the Supreme Court decision in *Woodward*, *Stempfel* was reversed by the Sixth Circuit *sub nom.* Third Nat'l Bank v. United States, 427 F.2d 343 (6th Cir. 1970).
in the stock redemption area. The court in Smith Hotel, however, concentrated on one specific aspect of the transaction, i.e., the litigation itself, while the business purpose cases examined the substance of the transaction as a whole. Indeed, the primary purpose test as applied by the court in Smith Hotel seems to be a much more formalistic approach than that taken by the business purpose cases, since it is only by virtue of the operation of the state statute that the "primary purpose" was held to be non-capital.

B. The Woodward and Hilton Decisions

It was against this background that the Supreme Court decided the companion cases of Woodward v. Commissioner and United States v. Hilton Hotels Corp. In Woodward, the individual taxpayers were part of the controlling group of shareholders of an Iowa corporation. The corporation's charter was expiring and the taxpayers' group voted to extend the charter in perpetuity. A minority shareholder dissented. Under Iowa law, those shareholders voting in favor of renewing a corporation's existence must purchase the shares of the dissenters. After negotiations with the dissenter proved unsuccessful, the majority shareholders filed suit in state court seeking to have the value of the dissenter's stock determined. The Iowa trial court did so, and, after the amount was reduced slightly by the Supreme Court of Iowa, the majority shareholders purchased the interest of the dissenter at the price fixed.

The taxpayers then attempted to deduct the expenses of the litigation under section 212 as expenses "for the management, conservation, or maintenance of property held for the production of income." The Commissioner denied the deduction on the ground that the appraisal costs were capital expenditures incurred in connection with the acquisition of the dissenter's stock.

In the Supreme Court, the taxpayers, attempting to classify the expenses as noncapital in nature, argued that the test to be applied was the primary purpose test of Smith. Aside from its application in that case, the test had previously been used by the courts principally in the determination of whether an expenditure was incurred in "defending or perfecting title to property." As in Smith, the

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138 Treas. Reg. § 1.263(a)-2(c) (1958). Under the "primary purpose" test if liti-
taxpayers in *Woodward* argued that the primary purpose of their expenditure was evaluation of the stock of the dissenter, not title determination.\(^\text{139}\)

The government in *Woodward* countered by arguing that the test to be applied was the "origin and character of the claim" test.\(^\text{140}\) That test had been established by the Supreme Court in *United States v. Gilmore*,\(^\text{141}\) where a husband had attempted to deduct the expenses incurred in defending claims to his property in a divorce action. The issue in *Gilmore* was whether the expenses were business expenses for the "conservation . . . of property held for the production of income,"\(^\text{142}\) or were instead personal in nature. There the Court held that the origin of the claim was the marriage relationship and that, since this was personal in nature, the deduction was to be denied.\(^\text{143}\) It found it unnecessary to pass upon the question of whether a portion of the expenses was capital in nature since in that event the deduction would have been denied as well.\(^\text{144}\)

In *Woodward*, the government contended that the origin of the claim litigated by the taxpayers was the acquisition of the dissenter's shares, and that the "character" of the claim — "the amounts to be paid for capital assets — indisputably was capital in nature."\(^\text{145}\) Therefore, the expenses should be capitalized. The Supreme Court agreed. In affirming the decision of the Eighth Circuit in favor of the government, the Court noted that generally "costs incurred in the acquisition or disposition of a capital asset are to be treated as capital expenditures."\(^\text{146}\) The Court then went on to apply Treasury Regulation § 1.263(a)-2(a) which states that "the cost of acquisition . . . of . . . property having a useful life substantially beyond the taxable year"\(^\text{147}\) is a capital expenditure.

\(^{139}\) See, e.g., *Rassenfoss v. Commissioner*, 158 F.2d 764 (7th Cir. 1946).


\(^{142}\) *Internal Revenue Code of 1954*, § 212.

\(^{143}\) *372 U.S. at 51*.

\(^{144}\) *Id.* at 52.


\(^{146}\) *397 U.S. at 575*.

\(^{147}\) *Treasury Regulation*, § 1.263(a)-2(a) (1958).
In specifically rejecting the primary purpose test, the Court stated:

That uncertain and difficult test may be the best that can be devised to determine the tax treatment of costs incurred in litigation that may affect the taxpayer's title to property more or less indirectly, and that thus calls for a judgment whether the taxpayer can fairly be said to be "defending or perfecting title." Such uncertainty is not called for in applying the regulation that makes the "cost of acquisition" of a capital asset a capital expense. In our view application of the latter regulation to litigation expenses involves the simpler inquiry whether the origin of the claim litigated is in the process of acquisition itself.

A test based upon the taxpayer's "purpose" in undertaking or defending a particular piece of litigation would encourage resort to formalisms and artificial distinctions. For instance, in this case there can be no doubt that legal, accounting, and appraisal costs incurred by taxpayers in negotiating a purchase of the minority stock would have been capital expenditures. See Atzingen-Whitehouse Dairy Inc. v. Commissioner, 36 T. C. 173 (1961). Under whatever test might be applied, such expenses would have clearly been "part of the acquisition cost" of the stock. . . . Yet the appraisal proceeding was no more than the substitute which state law provided for the process of negotiation as a means of fixing the price at which the stock was to be purchased. Allowing deduction of expenses incurred in such a proceeding, merely on the ground that title was not directly put in question in the particular litigation, would be anomalous.

The standard here pronounced may, like any standard, present borderline cases, in which it is difficult to determine whether the origin of particular litigation lies in the process of acquisition. This is not such a borderline case. Here state law required taxpayers to "purchase" the stock owned by the dissenter. In the absence of agreement on the price at which the purchase was to be made, litigation was required to fix the price. Where property is acquired by purchase, nothing is more clearly part of the process of acquisition than the establishment of a purchase price. Thus the expenses incurred in that litigation were properly treated as part of the cost of the stock which the taxpayers acquired.148

Finally, in a footnote, the Court discussed the involuntary nature of the purchase as follows:

In the first place, the transaction is in a sense voluntary, since the majority holders know that under state law they will have to buy out any dissenters. More fundamentally, however, whenever a capital asset is transferred to a new owner in exchange for value either agreed upon or determined by law to be a fair quid pro quo, the payment itself is a capital expenditure, and there is no reason why the costs of determining the amount of that payment should

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148 397 U.S. at 577-79 (footnotes omitted).
be considered capital in the case of a negotiated price and yet considered deductible in the case of the price fixed by law.149

United States v. Hilton Hotels Corp.150 was the companion case to Woodward. In Hilton, holders of about six percent of the stock of the Waldorf Astoria Corporation dissented from a statutory merger of Hilton Hotels Corporation with Waldorf and demanded payment for their shares.151 New York law provided that upon a statutory merger the surviving corporation must purchase the shares of the dissenters. After the merger was consumated, the surviving corporation (which retained the name Hilton) made a cash offer to the dissenters which was rejected by them. The dissenters then began appraisal proceedings in state court. In connection with the suit, which was ultimately settled, Hilton incurred consulting, legal, and other professional service expense, which it deducted under section 162. The Commissioner disallowed the deduction on the ground that the payments were capital expenditures.

Both the district court152 and the court of appeals,153 in holding for the taxpayer, had applied the primary purpose test. Interestingly, in the Supreme Court, Hilton appeared to concede that the "origin and character of the claim" test was more appropriate.154 Hilton maintained that under New York law title to the dissenters' stock had passed prior to the appraisal proceeding and that such proceeding therefore "did not involve the acquisition of stock."155 In this regard, Hilton attempted to distinguish the court of appeals decision in Woodward (a holding in favor of the government) on the ground that in Woodward title to the shares did not pass to the majority shareholders until after the appraisal proceedings had been concluded.156 Hilton asserted, as a second argument, that the merg-

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149 Id. at 579 n.8.
151 Hilton already owned close to 90 percent of Waldorf's stock at the time of the merger vote.
153 410 F.2d 194 (7th Cir. 1969).
154 See Brief for Respondents at 4, 10.
155 Id. at 3.
156 See Brief for Respondent in Opposition to Petition for Writ of Certiorari at 7-8; Respondent's Motion in Support of Petition for Writ of Certiorari at 2, United States v. Hilton Hotels Corp., 397 U.S. 580 (1970). Surprisingly, Hilton did not argue (at least not on brief) that capitalization of the appraisal expenses as part of the cost of the stock would lead (by virtue of Code section 1032) to their total nondeductibility. Nor did Hilton point out that the Waldorf stock had little asset significance to the surviving corporation. See notes 84-94 supra & accompanying text. By contrast, in Woodward,
er had also been consummated prior to the appraisal proceedings and that, therefore, those proceedings were not "functionally related" to the merger, negating the applicability of the general rule that costs of a reorganization must be capitalized. In short, the taxpayer's argument was that "the origin of the proceedings was a debtor-creditor relationship and the character of the proceedings was the determination of the amount of the debt." 158

The government, in Hilton, apparently confident of success in Woodward, argued that the Hilton and Woodward transactions were substantially identical. 159 Indeed, apparently to emphasize this point, the government filed a joint brief covering both cases. Supporting its petition for certiorari the government had urged that the expenses in Hilton were to be capitalized as either expenses of reorganization or as expenses of acquiring a capital asset. 160 In its principal brief, however, the government emphasized the latter position almost to the exclusion of the former. The main thrust of the government's argument was simply that passage of title to the dissenters' stock under state law was irrelevant and that "the principle that expenses incurred in connection with the acquisition of capital assets must be capitalized" 161 was applicable to both Woodward and Hilton.

Again the Supreme Court agreed with the government. In a brief opinion, the Court held, as it had in Woodward, that the primary purpose test was inapplicable and that the "expenses of litigation that arise out of the acquisition of a capital asset are capital expenses, quite apart from whether the taxpayer's purpose in incurring them is the defense or perfection of title to property." 162 The "chief distinction" seen by the Court between Hilton and Woodward was "that under New York law title to the dissenters' stock passed to Waldorf as soon as they formally registered their dissent, placing them in a relationship of creditors to the company for the fair value of the stock, whereas under Iowa law passage of the dissenters' stock was real asset significance to the taxpayers. And capitalization of the expenses would increase the taxpayers' basis, thus reducing their taxable gain upon resale.

157 Brief for Respondents at 7.
158 Id. at 10.
159 See Brief for the Government, Woodward & Hilton at 19.
160 See Petition for Writ of Certiorari at 7.
161 Brief for the Government, Woodward & Hilton at 18.
162 397 U.S. at 583.
title was delayed until after the price was settled in the appraisal proceeding.\textsuperscript{162a} The Court continued:

This is a distinction without a difference. The functional nature of the appraisal remedy as a forced purchase of the dissenters' stock is the same, whether title passes before or after the price is determined. Determination and payment of a price is no less an element of an acquisition by purchase than is the passage of title to the property. In both \textit{Woodward} and this case, the expenses were incurred in determining what that price should be, by litigation rather than by negotiation. The whole process of acquisition required both legal operations — fixing the price, and conveying title to the property — and we cannot see why the order in which those operations occurred under applicable state law should make any difference in the characterization of the expenses incurred for the particular federal tax purposes involved here.\textsuperscript{163}

C. \textit{How Was the Transaction in Hilton Viewed?}

From the standpoint of this discussion, the \textit{Hilton} case is of greater significance since that case is more closely analogous factually to a stock redemption by a single corporation than is \textit{Woodward}. The question, of course, is whether anything remains of the prior law of stock redemption expenses after \textit{Hilton}.

Unfortunately, there are factors that cut both ways. First, although the Court cited one of the simple acquisition cases,\textsuperscript{164} it is not clear to what extent the Court was aware of any of the other lines of authority.\textsuperscript{165} Nor is it clear which view of the transaction the Court was taking in \textit{Hilton}.

If the Court viewed the appraisal proceeding as merely incident

\textsuperscript{162a} Id. at 584.

\textsuperscript{163} Id.


\textsuperscript{165} The Supreme Court did not cite any of the partial liquidation or business purpose cases in either \textit{Woodward} or \textit{Hilton}. Moreover, only two redemption expense cases of any kind, one from the partial liquidation line, and one business purpose case, were cited to the Court, and those citations were only in passing. In its brief in opposition to the government's petition for certiorari, the taxpayer in \textit{Hilton} cited Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962) (partial liquidation), and General Pencil Co., 13 P-H Tax Ct. Mem. 689 (1944) (business purpose), along with a number of other cases, in the following context: "The following situations are but a few of those wherein legal fees were incurred and were declared to be non-capital expenditures: . . . the acquisition of stock to prevent a stockholder from further disrupting corporate operations [citing \textit{General Pencil}]; the working out of a purchase procedure and valuation formula for the purchase of a majority stockholder's holdings under a buy-sell agreement [citing \textit{Gravois}] . . . ." Brief for Respondents in Opposition to Petition for Writ of Certiorari at 5-6. Before the Court had acted on the government's petition for certiorari in \textit{Hilton}, it granted certiorari in \textit{Woodward}. Thereupon, by motion, the taxpayer in \textit{Hilton} withdrew its opposition to the government's petition for certiorari, the brief for which had contained the above citations. \textit{Hilton}
to the merger (i.e., part of the reorganization), then *Hilton* may have little effect on the partial liquidation and business purpose lines of authority. With regard to the partial liquidation line, it should be noted that although reorganization expenses have never been considered deductible, this has not prevented the courts in that line from holding for the taxpayer where the dominant aspect of a transaction was felt to be partial liquidation. Moreover, *Hilton* itself did not involve a partial liquidation (at least not in the sense of section 346), and does not, therefore, even inferentially support a proposition that in a section 346 transaction the expenses are to be considered expenses of reorganization, rather than expenses of partial liquidation.

As to the business purpose cases, if the Court in *Hilton* viewed the expenses merely as incident to the reorganization, then *Hilton* might be read to support the analysis of the business purpose line. By viewing the expenses as incident to the merger, the Court would be tracing them to the underlying business transaction. Where, unlike *Hilton*, the underlying transaction was not capital in nature the expenses would be deductible.

There is, however, much to indicate that the Court in *Hilton* viewed the expenses as subject to capitalization, not as reorganiza-

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*Gravois Planing Mill Co.*, holding that expenditures in connection with a partial liquidation may be deducted, presents a wholly different question and is to be contrasted with the subsequent decisions of the Eighth and Seventh Circuits in *United States v. Morton*, 387 F.2d 441, 448-450 (C.A. 8), and *Alphaco, Inc. v. Nelson*, 385 F.2d 244, 245 (C.A. 7). Brief for the Government, *Woodward & Hilton* at 17-18 n.12. (The two latter cases held that expenses of the sale of assets in a section 337 liquidation could not be deducted.)

Standing alone, these references might seem significant, but in the context of the principal arguments made by the parties, see note 156 and text accompanying notes 154-61 supra, they were hardly designed to call the Court's attention to the number of divergent lines of authority discussed earlier. Further, the only citation of any of the cases in these lines of authority in the lower court decisions in *Hilton* and *Woodward* was in the district court opinion in *Hilton*. See *Hilton Hotels Corp. v. United States*, 285 F. Supp. 617 (N.D. Ill. 1968). There, *Gravois* (partial liquidation) was cited as standing for the general proposition that expenses of a reorganization were to be capitalized. Even there, the citation was with reference to a point already conceded by the taxpayer, namely, the capital nature of expenses incurred prior to the merger. There was also a similar citation (merger expenses must be capitalized) of *Mills Estate* in *Vermont Bank & Trust Co. v. United States*, 296 F. Supp. 682 (D. Vt. 1969), discussed in note 178 infra. *Vermont* was decided after the trial court decisions in *Woodward* and *Hilton*, but was not cited by the Supreme Court. Indeed, none of the cases that were cited by the Court made any reference to the partial liquidation or business purpose cases. Finally, it should be noted that Mr. Justice Blackmun, who wrote the opinion in *Gravois* and sat on the panel in *General Bancshares*, was not yet on the Court when *Woodward* and *Hilton* were decided.
tion expenses, but as expenses connected with the purchase of a capital asset, *i.e.*, the dissenters' stock. As mentioned previously, although the government in *Hilton* argued in its petition for certiorari that the expenses were to be capitalized either as expenses of reorganization or as expenses of acquiring a capital asset, in its principal brief the government rested its case almost exclusively upon the capital asset acquisition analysis. And the opinion in *Hilton* indicates that the Court adopted the latter view.

Nevertheless, this alone does not answer the basic inquiry. The question now becomes: Was the Court viewing the transaction in *Hilton* as the purchase by a corporation of its own stock or, instead, viewing the transaction as the purchase by one corporation of the stock of another? In the Hilton-Waldorf merger, Hilton was substantially larger than Waldorf and already owned close to 90 percent of Waldorf. Further, the dissenters were shareholders of Waldorf. Thus, it is possible that the Court viewed the transaction as the purchase by the pre-merger Hilton corporation of the stock of the Waldorf dissenters. If this is so, the previous cases may be unaffected. Again, it was well settled prior to *Hilton* that the expense of purchasing the stock of another corporation is generally to be capitalized, and this rule did not seem to hamper the development of either the partial liquidation or business purpose lines.

Unfortunately, it is not clear how the Court was viewing the stock purchase. In its *Hilton-Woodward* brief, the government referred repeatedly to "acquisition of shares of stock" without specifying exactly which corporation it thought to be the purchaser. However, at one point the government said "[T]o accomplish the merger, Hilton had to acquire all of the Waldorf shares not held by it." While the reference to Hilton may be to the

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166 *See* text accompanying note 160 *supra.*
167 *See* text accompanying notes 160-61 *supra.*
168 *See* text accompanying notes 162-63 *supra.*
169 *See,* *e.g.*, Brief for the Government, *Woodward & Hilton* at 13.
170 *Id.* at 26. The full paragraph was:
It is not entirely clear what significance Hilton attempts to attribute to the fact that the dissenters' rights in *Woodward* arose out of the renewal of a corporate charter rather than a merger. Hilton's contention presumably is that, unlike *Woodward*, its case involves a reorganization and not a stock acquisition. Such an argument hardly comports with the facts, for in order to accomplish the merger, Hilton had to acquire all of the Waldorf shares not held by it. The obligation to exchange something of value for those Waldorf shares (Hilton stock for the assenting shareholders and cash for the dissenters) was an inherent part of the merger.

*Id.* at 25-26.
surviving corporation, (which of course, in a way, consists of the substance of both pre-merger corporations) the reference to shares not held by Hilton seems to support the idea that the government viewed the transaction as the purchase by the pre-merger Hilton corporation of the stock held by the outside Waldorf shareholders.

The opinion in *Hilton* also contains some indication that the Court viewed the transaction as the purchase by one corporation of the stock of another.

First, the Court saw little difference between the *Hilton* and *Woodward* transactions. And of course *Woodward* involved the purchase of shares by an individual, where the inherent asset significance of the stock to the purchaser is similar to the inherent asset significance of the stock of one corporation in the hands of another. In this regard it should be noted that in stating the general rule, the Court in *Woodward* said:

> Since the inception of the present federal income tax in 1913, capital expenditures have not been deductible. . . . Such expenditures are added to the basis of the capital asset with respect to which they are incurred, and are taken into account for tax purposes either through depreciation or by reducing the capital gain (or increasing the loss) when the asset is sold.

As mentioned previously, under the 1954 Code a corporation recognizes no gain or loss upon the sale of its own stock. Further, note that the Court in *Woodward* speaks of a capital asset being transferred to a new "owner." The concept of ownership, at least for tax purposes, also seems foreign to a corporation's rights in its own repurchased shares.

Finally, the opinion in *Hilton* contains some language to indicate that the Court viewed the transaction as the purchase by one corporation of stock of another:

> Hilton also argues that the appraisal costs cannot be considered as its own capital expenditures, since Waldorf acquired the shares (on December 28) before the merger (on December 31). This argument would carry too far. It is true that title to the dissenters' stock passed to Waldorf before that corporation was merged into the surviving corporation, Hilton. But the stock was never paid for by Waldorf; rather Hilton assumed all of Waldorf's debts under the merger agreement, and finally paid for the stock after the appraisal proceeding was settled. If Waldorf's acquisition of the minority stock interest was not a capital transaction of Hilton's, then Hilton's payment for the stock itself, as well as the expendi-

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171 See text accompanying note 163 supra.
172 397 U.S. at 574-75.
173 See text accompanying note 149 supra.
tures made in fixing that price, would lose its character as a capital expenditure of Hilton's. But Hilton concedes that the payment for the stock was a capital expenditure on its part.\(^\text{174}\)

On the other side of the argument is the fact that the language quoted above was followed immediately by these words: "The debts that Hilton inherited from Waldorf retained their capital or ordinary character through the merger, and so did the expenditures for fixing the amount of those debts."\(^\text{175}\) This would indicate that the Court saw the transaction as the purchase by Waldorf of its own shares followed by the assumption of the resulting liability by the surviving corporation. Further, one might point to the Court's citation of *Atzingen*,\(^\text{176}\) a simple acquisition case involving only a single corporation's purchase of its own shares. To complicate matters, *Atzingen* was not again cited in *Hilton* but, instead, only in *Woodward*,\(^\text{177}\) where the shares of the dissenters had been purchased by the other shareholders.\(^\text{178}\)

\(^{174}\) 397 U.S. at 584-85 (emphasis added).

\(^{175}\) Id. at 585.


\(^{177}\) See text accompanying note 148 *supra*.

\(^{178}\) With regard to the problem of how to view appraisal proceedings, see Vermont Bank & Trust Co. v. United States, 296 F. Supp. 682 (D. Vt. 1969), where the court dealt with the question more fully than did the Supreme Court. *Vermont* was decided after the Tax Court decision in *Woodward* and the district court decision in *Hilton*. In *Vermont*, there was a statutory merger. After appraisal proceedings had been completed, and the dissenters had been paid, one of the dissenters filed suit against the surviving corporation (the taxpayer) alleging that the appraisal of her shares was improper, and that she was entitled to a judgment of $40,000 or a new appraisal. The suit was ultimately settled for $1,250. In the process, the corporation incurred approximately $5,000 in legal expenses. The district court held that the legal fees were deductible, but the settlement amount was not. As to the legal fees, the court rejected the origin of the claim test, pointing out that in *Gilmore* the question was whether the expenses were personal or business and not whether the expenses must be capitalized. The court also resisted the government's attempt to characterize the expenses as reorganization expenses, stating that, although they originated in the merger, they were "not used to create, improve or defend" that merger. *Id.* at 685. With respect to the applicability of the Tax Court decision in *Woodward*, the court stated:

Without deciding the correctness of *Woodward* or the applicability of its principle to a case in which a corporation purchases the shares of one of the corporations from which it was formed, this Court concludes that the peculiar facts of this case make *Woodward* inapplicable. In 1956, Mrs. Sloan received a check for $12,500 for her shares of First National Bank of Bennington stock and at that time she cashed the check. Therefore, the sale of stock from Mrs. Sloan to the plaintiff was completed in 1956. It was not until three years after the sale that Mrs. Sloan brought suit. Because of the time lapse, and the fact that Mrs. Sloan had already received payment for her stock, the legal expenses in connection with the suit are too remote to be characterized as expenditures for purposes of purchasing a capital asset. *Id.* at 685-86 (footnotes omitted). As to the settlement amount, the court held that it was to be characterized as additional compensation for the shares. The Supreme Court did not cite *Vermont* in either *Woodward* or *Hilton*.\(^\text{178}\)
What little case law that has come down since *Hilton* is not very illuminating on the question of how the Court viewed the facts before it. The most ambitious attempt at an analysis has come from Judge Tannenwald of the Tax Court. In *Deering Milliken, Inc.*, the issue was whether appraisal litigation expenses, incurred upon a consolidation, could be amortized by the surviving corporation under section 248. The taxpayer argued, and the court agreed, that the "origin of the claim" test applied in *Woodward* and *Hilton* was a "but for" test. "The critical question," said the court, "is 'but for' what?" The taxpayer argued that "but for" the creation of the new corporation no appraisal litigation would have occurred and therefore such costs were "incident to the creation of the corporation" within the meaning of section 248. Judge Tannenwald disagreed:

[T]he expenses of the appraisal proceedings [in *Hilton*] originated in the agreement to consolidate and the resulting rights of the dissenters to have their interests acquired, i.e., "but for" that agreement, none of the subsequent events would have occurred and the expenditures of the appraisal proceedings would not have been made.

Judge Tannenwald pointed out that the consolidation in the case at hand would have occurred under state law whether or not the dissenters sought appraisal of their stock. Thus "the costs of the appraisal proceedings were not made to bring [the new corporation] into being" and were "not related in function to the creation of the new corporate entity." Consequently, amortization under section 248 was denied.

For purposes of analysis, Judge Tannenwald's characterization of the origin of the transaction in *Hilton* is not very helpful. The portion of his language which refers to the "agreement to consolidate" indicates that the expenses in *Hilton* were regarded as reorganization expenses. But the balance of Judge Tannenwald's opinion is inconsistent with this approach. On the other hand, the reference to "the resulting rights of the dissenters to have their interests acquired," while cutting in favor of the acquisition cost analysis, does not help determine who the purchaser was thought to be.

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179 59 T.C. 469 (1972).
180 Id. at 471-72.
181 Id. at 472.
182 Id.
183 Id.
184 Id.
IV. THE ORIGIN AND CHARACTER OF A REDEMPTION TRANSACTION

Assuming that the transaction in Hilton was viewed by the Supreme Court as the purchase by a corporation of its own stock, it is possible that the case supplants the prior law of stock redemption expenses. There may, however, still be hope for corporate taxpayers attempting to obtain a deduction. If Hilton controls, presumably the "origin and character" test must be applied to the expenses to determine whether they can be deducted. Indeed, it is conceivable that the ever expanding application of that test would have led to its eventual encroachment upon the redemption expense area of the law in any event. Further, application of the origin test might bring a semblance of order to this otherwise confused and perplexing area — at least a minor blessing to tax attorneys, regardless of deductibility.

It will be remembered that the more recent pre-Hilton authorities leaned in favor of allowing deductibility for expenses connected with a section 346 type of transaction while denying such treatment for expenses of a section 302 transaction.

Assume, then, a simple section 346 transaction. A corporation operates gasoline stations and manufactures men's clothing. The board of directors decides to take the corporation out of the clothing business. The corporation adopts a plan under which the assets of the clothing business are to be distributed to the shareholders pro rata in exchange for a percentage of each shareholder's stock.

184 It should be noted that while the origin and character test has traditionally been applied in the context of litigation expenses, there would seem to be no reason why it should not also be applied to expenses of matters which are resolved prior to the litigation stage. Thus, the Court in Woodward implied that it would be "anomalous" to treat expenses of negotiation and expenses of litigation differently where both involve the same subject matter. See text accompanying note 148 supra. Of course, many stock redemption expenses do not even involve negotiation between the shareholder and the corporation, e.g., a pro rata distribution pursuant to a section 346 partial liquidation. In such case, it would be difficult to seek out the origin and character of the "claim", there being no claim. However, there appears to be no reason why one could not substitute the word "transaction" for "claim" and apply the test on that basis, i.e., the origin and character of the transaction. Cf. Iowa So. Util. Co. v. Commissioner, 333 F.2d 382, 388 (8th Cir.), cert. denied, 379 U.S. 946 (1964), where the test was described as follows:

The Supreme Court tells us that "it is the origin of the liability" and "the kind of transaction out of which the obligation arose and its normalcy in the particular business which are crucial and controlling." [Citing Deputy v. Du Pont, 308 U.S. 488 (1940), and United States v. Gilmore, 372 U.S. 39 (1963)].

185 See notes 49-65 supra & accompanying text.
In effecting the transaction, the corporation incurs legal and accounting expenses.

The question would appear to be whether the origin and character of the transaction is (a) partial liquidation, (b) the acquisition of shares, or (c) recapitalization. If the origin and character is partial liquidation, then the expenses should be deductible on the same basis as they were before Hilton, i.e. by analogy to expenses of complete liquidation. If the origin and character of the transaction is the acquisition of shares or recapitalization, the expenses would have to be capitalized.

However, before applying the origin and character test to the hypothetical posited above, some analysis of the test itself is called for. As noted in Deering Milliken, Inc.,186 the test has been called a "but for" test. Unfortunately, this is not helpful in predicting what the result will be in any given case. Thus, in Gilmore the Supreme Court found that the origin of the wife's claim relating to the existence of community property was the marriage relationship, i.e., "no such property could have existed but for the marriage relationship."187 However, on the Gilmore facts, one could have as easily said that "but for" the taxpayer's ownership of the property there could have been no claim at all. Similarly, in Hilton and Woodward, the Court said that acquisition of the stock was the origin of the claim. Yet, in Woodward it could just as easily have been said that the "but for" element was the extension of the corporation's charter;188 and, in Hilton, it could have been said that "but for" the merger, no claim would have existed189 (which, incidentally, would lead to the conclusion that the expenses were reorganization expenses, rather than expenses of stock acquisition).

Given the inherent uncertainty of a "but for" test, one is compelled to search for a further rationale implicit in its application by the Court. In other words, why did the Court in Gilmore say that the origin of the claim was the marriage relationship, and why in Woodward and Hilton was the origin of the claim acquisition of stock?

The answer may be that the test is more than a "but for" test.

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186 59 T.C. 469 (1972).
187 372 U.S. at 52.
188 See Gibbs, Legal Fees: Supreme Court Cases Requiring Capitalization Will Have Broad Impact, 33 J. TAX. 201, 202 (1970).
189 Id.
and, further, that it is to be applied differently in different contexts. In this regard, it should be noted that the origin of the claim test seeks out not only a claim’s "origin," but its "character" as well.

In Gilmore, the Court stated the issue as follows: "[D]id the wife’s claims respecting respondent’s stockholdings arise in connection with his profit-seeking activities?" The word "arise" connotes more than "but for" causation. Further, the Court paid little attention to the fact that the character of the claim was in the nature of ownership of income-producing property. Thus, in a business versus personal context, the emphasis may be on the origin of the claim; specifically, on the relationship in which the claim "arises."

On the other hand, in a capital versus noncapital context, the emphasis may be on the character of the claim. Thus, while at one point the Court in Hilton said that "the expenses of litigation that arise out of the acquisition of a capital asset are capital expenses," the bulk of the Court’s argument in Hilton and Woodward centered around the fact that the function of the litigation was to fix the purchase price, and that fixing of the price was "clearly part of the process of acquisition." The Court also said that the appraisal proceedings were a substitute for the process of negotiation. Such language seems directed more toward the "character" of the claim, than its "origin." In short, while the Court uses the same test, in varying contexts that test can produce very different approaches.

It should also be noted that the "character" portion of the origin and character test is different from the "primary purpose" test which was rejected by the Court in Woodward and Hilton. The

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190 372 U.S. at 51.
191 397 U.S. at 583 (emphasis added).
[T]he "origin" of Mrs. Quigley’s [the dissenting shareholder] claim to payment for her shares, and the claim of the dissenting Waldorf shareholders with respect to which the appraisal expenses were incurred, was the acquisition of their stock by Woodward and Hilton. The "character" of the claims — the amounts to be paid for capital assets — indisputably was capital in nature.

Brief for the Government, Woodward & Hilton at 14-15. It is this last sentence that the Supreme Court seems to have focused upon when it stated:
[T]he appraisal proceeding was no more than the substitute that state law provided for the process of negotiation as a means of fixing the price at which the stock was to be purchased.
193 397 U.S. at 584.
194 See text accompanying note 148 supra.
character test is an objective test, while the primary purpose test is subjective in nature. Further, the character test views a transaction more as a whole, while the primary purpose test is more conducive to breaking the transaction down into its individual parts. In short, the character test looks to what is the overriding nature of a transaction, while the primary purpose test looks to the motivation of the parties involved.

Turning back to the hypothetical and beginning with partial liquidation vis-à-vis share acquisition, the corporate taxpayer described above can make some strong arguments that the "origin and character" of the transaction is partial liquidation and not stock acquisition. First, to the extent that a "but for" test is to be applied it could easily be said that "but for" the corporate contraction there would have been no stock redemption. In other words, it could be said that the transaction "arose" out of the decision to contract the scope of corporate activities. And corporate contraction is what makes a partial liquidation analogous to complete liquidation.

As to the character of the transaction, it would seem that the stock redemption portion of the transaction is at best only incidental to the plan. Since the redemption is pro rata, neither the corporation nor the shareholders would be concerned with the number of shares redeemed or the price paid per share. Whether one percent of each shareholder's stock is redeemed or ninety-nine percent, after the transaction is completed there will be precisely the same number of shareholders as before, each of whom holds exactly the same percentage interest in the corporation as was held previously.

The only reason for the stock redemption portion of the transaction, then, is to obtain sale or exchange as opposed to dividend treatment for the shareholders. Of course it could be argued that if reliance is to be placed upon section 346 for the analogy to complete liquidation, one must take the bad with the good; and section 346 appears to require stock redemption. However, even here there are indications that the redemption requirement is not to be taken too seriously; at least not seriously enough to characterize the redemption portion of the transaction as any more than incidental. Thus, one court has held that with a pro rata distribution no stock redemption at all is required for section 346 to operate. More-

195 Fowler Hosiery Co. v. Commissioner, 301 F.2d 394, 397 (7th Cir. 1962), aff'd 36 T.C. 201, 220-21 (1961) (sole shareholder). But see Jason L. Honigman, 55 T.C. 1067, 1079-80 (1971), aff'd, 466 F.2d 69, 74 (6th Cir. 1972), which, in a non pro
over, the Service has ruled that the number of shares actually re-
demed by the corporation in a section 346 transaction is irrelevant
in determining gain or loss to the shareholders — at least where
there has been a pro rata redemption. In such case "the total num-
ber of shares deemed to have been surrendered is that number
which bears the same ratio to the total number of shares outstand-
ing as the cash distributed bears to the total fair market value of
the net assets of the corporation immediately prior to the distribu-
tion." 196

It should also be noted that there are transactions resembling
section 346 partial liquidations involving no stock redemption at
all. For example, no stock redemption took place in the "D"
reorganization in General Bancshares. 197 Furthermore, consider-
ing the absence of share acquisition, it is arguable that the holding
of General Bancshares would be unaffected by Hilton. Therefore,
itis still may be assumed that expenses of a "D" reorganization are
deductible. And it would make little sense to allow the taxpayer in
a "D" reorganization to deduct its expenses, while denying such
treatment to the taxpayer in a section 346 transaction.

However, before assuming that the share acquisition aspect of
a section 346 transaction is sufficiently incidental to preclude its
identification as the transaction's origin and character, a compari-

196 Rev. Rul. 56-513, 1956-2 CUM. BULL. 191, 192. See also Rev. Rul. 68-348,
1968-2 CUM. BULL. 141; Rev. Rul. 59-240, 1959-2 CUM. BULL. 112; Rev. Rul. 57-
334, 1957-2 CUM. BULL. 240.

197 United States v. General Bancshares Corp., 388 F.2d 184 (8th Cir. 1968).
son to the share acquisition aspect of the transaction involved in Hilton is necessary. There, it will be remembered, the taxpayer made a similar argument and it was rejected by the Court. The section 346 transaction of the hypothetical, however, is distinguishable from the transaction in Hilton. The taxpayer in Hilton argued that legal title to the shares was not in issue in the appraisal proceeding.\textsuperscript{188} It could not assert, however, that the dissenters' monetary interest in the shares was irrelevant. Indeed, the essence of the Supreme Court's holding was that the function of the appraisal proceedings was to determine the price to be paid for the shares, and this, the Court said, was an element of acquisition.\textsuperscript{189} By contrast, in a pro rata section 346 distribution, the price of the shares is irrelevant. Moreover, the corporation is not interested in acquiring the shareholder's interest, monetary or otherwise. In sum, there appear to be rather persuasive arguments that the origin and character of a straight section 346 transaction is partial liquidation as opposed to share repurchase.

Next, is it possible to identify the origin and character of the section 346 hypothetical in terms of recapitalization,\textsuperscript{200} remembering that the tax treatment flowing from such an identification would be the same as that flowing from a share acquisition characterization? In this regard, what the corporation does with the redeemed shares may be important. In three of the earlier partial liquidation cases,\textsuperscript{201} the courts held that the dominant aspect of the transactions before them was recapitalization. This conclusion was apparently based in part on the fact that in each of those cases the corporation had cancelled the redeemed stock and had thereby reduced its stated capital. Thus, a corporation's position might be stronger if it held the redeemed shares in its treasury. This would avoid

\footnotesize{\textsuperscript{188} See text accompanying notes 155-56 supra.}
\footnotesize{\textsuperscript{189} See text accompanying note 163 supra.}
\footnotesize{\textsuperscript{200} Rather than apply the "origin and character" test throughout, it might be possible to take another approach. Once it is decided that the "origin and character" of the transaction is not "in the process of acquisition" of shares, one could then revert back to the "dominant aspect" test of Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962), to determine whether the "dominant aspect" of the transaction is recapitalization or partial liquidation. However, in the capital versus non-capital context, the emphasis of the origin and character test appears to be upon the "character" of a transaction as opposed to its "origin." See notes 192-93 supra & accompanying text. And "character" appears sufficiently synonymous with "dominant aspect" to allow application of the "origin and character" test throughout, without a significant difference in result.}
\footnotesize{\textsuperscript{201} Farmers Union Corp. v. Commissioner, 300 F.2d 197 (9th Cir.), \textit{cert. denied}, 371 U.S. 861 (1962); Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953); Standard Linen Service, Inc., 33 T.C. 1 (1959), acquiesced in, 1960-2 \textsc{Cum. Bull.} 7.
the reduction of stated capital that attends share cancellation under most corporate statutes.²⁰²

Noncancellation, however, may create problems for the taxpayer in presenting its argument that the origin and character of the transaction is not stock acquisition. In Hilton, the New York statute provided that:

the shares or other securities of the resulting or surviving corporation into which the shares of the objecting stockholder would have been converted had no objection been made shall, unless the certificate of merger or consolidation shall otherwise provide, be deemed to have been duly issued in accordance with the terms of such certificate and reacquired by the resulting or surviving corporation, and may be held or disposed of by it free of any preemptive rights of stockholders.²⁰³

This portion of the statute was set out in the district court opinion and it is conceivable that the Supreme Court decision was influenced by the fact that the dissenters' stock became treasury stock of the surviving corporation.

Perhaps the solution to this cancellation dilemma may lie in a compromise measure. In two of the early partial liquidation cases,²⁰⁴ there was not only share cancellation but also a charter amendment. To some extent, this additional factor might have influenced the conclusion that a recapitalization had taken place.²⁰⁵ If the shares are cancelled without a charter amendment,²⁰⁶ it may be possible to avoid at least one of the principal factors pointing in favor of recapitalization, while at the same time avoiding a factor pointing in favor of share acquisition. It might also be possible to negate the capital reduction by immediately restoring to stated capital the amount lost through the share cancellation.²⁰⁷

In any event, distinctions based on whether the shares are cancelled or held in the treasury will not be determinative in this area. It should be noted that section 317, which defines redemption,

²⁰²See, e.g., MBCA § 68.
²⁰⁵The court in Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962), implied that this was a factor cutting in favor of recapitalization characterization in the earlier cases. Id. at 208. See text accompanying notes 37-38 supra.
²⁰⁶See, e.g., MBCA § 67 (permitting cancellation of shares without article amendment).
²⁰⁷See, e.g., MBCA § 21 (permitting the board of directors to transfer all or part of the corporation's surplus to stated capital).
makes no distinctions on the basis of share cancellation.\textsuperscript{208} This appears to have been a deliberate attempt by Congress to avoid the types of distinctions made by some courts under the 1939 Code.\textsuperscript{209}

Aside from the cancellation problem, there is nothing that would indicate that the origin and character of a section 346 transaction is recapitalization. No new securities are being issued. Further, no reshuffling of the interest of any of the shareholders is taking place;\textsuperscript{210} the shareholders are in exactly the same position as before, both vis-a-vis each other and vis-a-vis the corporation. On balance, then, it would appear that in a simple section 346 transaction, the origin and character of the transaction is partial liquidation rather than either share acquisition or recapitalization.

To evaluate the effect of the origin and character test on a simple redemption situation a different hypothetical is necessary. Assume a corporation with three or four shareholders, one of whom wishes, for personal reasons, to retire from the business. The corporation purchases all of his stock for cash and there is no stock outstanding which may be attributed to him. There is no corporate contraction concurrent with the redemption and there is no separate business purpose for the transaction. It seems clear that after Hilton such a simple section 302 redemption transaction should not give rise to a deduction for the expenses involved. The origin and character of such a transaction would seem to be share acquisition at least to the same extent as the transaction in Hilton. Further, if the more recent pre-Hilton partial liquidation authorities\textsuperscript{211} are to

\textsuperscript{208} Technically, section 317 does not apply to section 346; however, this appears to have been an oversight in drafting. BITTNER \& RUSTICE § 9.52.

\textsuperscript{209} Under the Int. Rev. Code of 1939, 53 Stat. 1, and its predecessors, several early cases held that there could be no "cancellation or redemption" and hence no partial liquidation, see text accompanying note 40 supra, if the repurchased stock was to be held in the treasury instead of being cancelled. E.g., W. C. Robinson, 42 B.T.A. 725 (1940). Most of the later cases abandoned that distinction in favor of the view that a repurchase of stock to be held in the treasury nevertheless constituted a "redemption." E.g., Wilson v. United States, 257 F.2d 534, 536-37 (2d Cir.), cert. denied, 358 U.S. 893 (1958). For a more complete discussion see Herwitz, Stock Redemptions and the Accumulated Earnings Tax, 74 HARV. L. REV. 866, 893 n.80 (1961). Notably, the earlier view was held, for a time, by the Second Circuit. See Alpers v. Commissioner, 126 F.2d 58 (2d Cir. 1942). This makes somewhat anomalous the Second Circuit's implication in Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953), that the reduction of capital resulting from cancellation of the repurchased shares was indicative of a recapitalization, as opposed to a partial liquidation, for the purpose of determining the deductibility of the expenses. Indeed, two of the judges who decided Mills (Swan and Chase) had some years before formed the majority in Alpers (holding no partial liquidation without cancellation).

\textsuperscript{210} See note 48 supra.

\textsuperscript{211} See note 65 supra & accompanying text.
be a guide, the character of a simple section 302 redemption would have to be called recapitalization.

There are some transactions, however, which contain elements of both section 302 and section 346 in that they involve both a non pro rata distribution and a corporate contraction. Although section 346 provides that where a transaction qualifies under both sections it is to be treated under section 346, it is unlikely that this provision would be determinative of the deductibility of the expenses.

The difficulty with such a mixed transaction is that it has several “characters” — partial liquidation, share acquisition, and recapitalization. Thus, the “character” portion of the origin and character test, alone, will not provide the answer. Perhaps, in such circumstances, it might not be inappropriate to seek guidance in the “origin” portion of the test. Judging by the Supreme Court opinion in Gilmore, the question would be under what circumstances did the transaction “arise.” Thus, in a given case, if it had been determined that a shareholder’s interest in the corporation ought to be decreased, and the contraction took place to accomplish that goal, the origin and character of the transaction would be share acquisition or recapitalization. On the other hand, if it had been decided that corporate contraction was necessary, and an offer of redemption was made to all the shareholders, the origin and character of the transaction should be partial liquidation, even though the offer turned out to be accepted by only one or two shareholders.

Of course, in the context of a closely held corporation, which goal predominated might be difficult to determine even for those involved in the decision. Even where such is not the case, the burden of proving that a specific goal was foremost would be extremely difficult to meet. Finally, making an offer of redemption to all the shareholders would be no panacea, for, in the context of a close-

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213 Section 346(c) is apparently designed to avoid having the technical requirements of section 302 applied to a transaction that meets the requirements of section 346. See Treas. Reg. § 1.346-2 (1955).
215 The analysis at this point admittedly calls for somewhat subjective judgements. When a transaction has several “characters,” however, some reference to the motivation of the parties may be unavoidable. This is not to suggest that the analysis being applied here is identical to the primary purpose test that was rejected by the Court in Woodward and Hilton. For, as noted previously, that test, in addition to being subjective, tended when applied to appraisal expenses to be formalistic and to operate on a rather narrow aspect of the transaction. See text immediately following note 135 supra.
ly held corporation, it would be hard to prove that there was no prearrangement that less than all would accept.

Next, what is the effect of the origin and character test in a situation where there is a strong noncapital business purpose for the redemption? First, it should be noted that to the extent the origin and character test is a "but for" test, the presence of a strong business purpose could easily lead to that purpose being identified as the origin of the transaction. In other words, in a case like General Pencil, the taxpayer could easily argue that "but for" the business need, no redemption would have taken place. The real question, however, is whether it is possible, after Hilton, to characterize any simple non pro rata redemption (i.e., one with no corporate contraction) as anything but share acquisition. From a policy standpoint, considering the analogies which can be drawn, the answer should be in the affirmative.

Illustrative are the supply cases. Prior to Hilton, it was fairly well established that a corporation could deduct from ordinary income any loss sustained on the sale of stock purchased by it in order to obtain a source of supply of goods. This, of course, was an exception to the general rule that losses on capital assets are deductible by a corporation only to the extent of gains on such assets. The supply cases might also be viewed as an exception to the general rule that the cost of acquiring a capital asset is a capital expenditure — the latter rule being the one upon which the decisions in Hilton and Woodward were based. It may be that the rule of the supply cases survives Hilton and Woodward to the extent it survived the general rules prior to Hilton. If this is true, it would make little sense to allow such an ordinary loss deduction and to deny a deduction for the expenses of a redemption where an equally strong noncapital business purpose can be shown. Indeed, the decision in Five Star (a business purpose case) was based, at least in part, on an analogy to the supply cases.

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217 See authorities cited note 115 supra.
218 Indeed, the Service has not revoked the 1958 Revenue Ruling in which it accepted the proposition that losses on what otherwise would be capital assets (stocks and bonds) are deductible in full, if the securities were purchased to obtain a source of supply, or to satisfy other current business needs (such as the purchase of government bonds to be placed in escrow in order to guarantee performance of a contract entered into by the taxpayer). Rev. Rul. 58-40, 1958-1 Cum. Bull. 275.
220 Id. at 727.
There is also the analogy to proxy fight expenditures, which, it will be remembered, are deductible provided "such expenditures were primarily concerned with a question of corporate policy."\textsuperscript{221} This rule undoubtedly survives \textit{Hilton} because of the absence of any share acquisition in the normal proxy battle.\textsuperscript{222} As noted previously, in a closely held corporation, matters of corporate policy can often be settled only by share redemption. And, even where a proxy fight is a viable alternative to share redemption, the latter is often the more convenient alternative. Again, it seems inconsistent to allow deductibility for expenses of one method of resolving questions of corporate policy while denying it for expenses of another method.

Unfortunately, after \textit{Hilton}, there may be no escaping the argument that, regardless of the business purpose involved, the character of a simple non pro rata redemption (one with no corporate contraction) is share acquisition. The Supreme Court's citation of \textit{Atzingen} in \textit{Woodward} lends some support to this approach, for, it will be remembered, in \textit{Atzingen} the court rejected the taxpayer's assertion that the redemption was necessary to eliminate shareholder friction.\textsuperscript{223} Further, the Supreme Court's failure to characterize the expenses in \textit{Hilton} as reorganization expenses indicates that the underlying business transaction was not regarded as controlling.

One thing that can safely be assumed with regard to the business purpose approach is that the holding of \textit{Five Star} (that the purchase price itself may be deducted) runs counter to the spirit of \textit{Hilton} and \textit{Woodward}. But this alone should not mean that the expenses of a business purpose redemption should not be deductible. It is possible to regard the purchase price as a distribution of the corporation's "capital"\textsuperscript{224} while considering the expenses of the transaction in light of the business need to eliminate the shareholder involved.

V. \textbf{THE POST-HILTON CASES}

What few decisions that have come down since \textit{Hilton} in the stock redemption expense and related areas have not shed much light on future developments. There have been two cases which

\textsuperscript{221} Rev. Rul. 67-1, 1967 CUM. BULL. 28; see authorities cited note 116 supra.
\textsuperscript{222} BITTKER & EUSTICE § 5.04, at 5-10.
\textsuperscript{223} See text accompanying note 75 supra.
\textsuperscript{224} In the broad sense of "proprietorship." See note 2 supra.
might be classified as business purpose cases. There has also been one case in the partial liquidation line, and one tangentially related thereto.

In one of the business purpose cases, White Star Drive-In Laundry & Cleaners, Inc. v. United States, one of the corporation's 50-percent shareholders became dissatisfied with the management of the corporation and filed suit in state court seeking dissolution of the corporation. In settlement, the corporation purchased his shares. Thereafter, the corporation sought to deduct the full purchase price of the shares.

The court, applying the origin and character of the claim test, held that the expenditure was not deductible. The court, however, did not hold that the origin of the claim was share acquisition. Instead, Judge McGarr stated that the state court suit in question "sought dissolution of the corporation, the appointment of a receiver, and a distribution of the proceeds from the sale of assets. It is difficult to imagine a claim which is more capital in nature." The result may be correct in light of the fact that the expenditure at issue was the purchase price of the shares. However, the notion that avoiding liquidation is capital in nature runs counter to the view taken by most other courts that have considered the question. For example, in Western Grain Co. v. Patterson, expenses of defending a shareholder suit calling, inter alia, for dissolution were held to be deductible. Even in the pre-Hilton simple acquisition case of Annabelle Candy, the court implied that expenses of avoiding liquidation would be deductible. And, of course, avoiding liquidation was held, in part, to be the basis for allowing the deduction in the pre-Hilton business purpose cases of Five Star and General Pencil.

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226 No mention was made in the opinion of the expenses of the transaction.
227 The court did not cite Hilton or Woodward but relied instead upon Anchor Coupling Co. v. United States, 427 F.2d 429 (7th Cir. 1970), cert. denied, 401 U.S. 908 (1971), in which the Seventh Circuit had applied the origin and character test of Hilton and Woodward to a settlement payment in a suit for specific performance of a contract for the sale of assets. The deduction was denied in Anchor.
228 59-2 U.S. Tax Cas. 73,466 (N.D. Ala. 1959).
230 See text accompanying note 78 supra.
The other business purpose case decided after Hilton was Keenan Pipe & Supply Co. v. United States.\textsuperscript{234} There the court allowed the corporation to deduct legal fees incurred in the preparation of a stock purchase agreement which gave the corporation an option to purchase the shares of its stockholders upon death. The court said that "[t]he new agreement benefitted [the company] since it served the purpose of insuring that stock of a deceased Shareholder would not be sold or transferred to unknown parties who might cause friction in the corporate management."\textsuperscript{235} No cases were cited.

Turning to the partial liquidation line: In Thompson & Green Machinery Co. v. United States,\textsuperscript{236} the corporation, through three subsidiaries, was a franchised Caterpillar dealer in both Tennessee and Alabama. Caterpillar did not want to be represented by the same interests in two separate territories. To satisfy Caterpillar, the taxpayer merged with one of its subsidiaries. What happened thereafter is not entirely clear from the opinion. Apparently, the stock of the two other subsidiaries was split off to three of the corporation’s shareholders in exchange for the stock these three held in the taxpayer corporation. The district court held that the expenses of the transaction were not deductible. Citing \textit{inter alia}, Mills Estate,\textsuperscript{237} General Bancshares,\textsuperscript{238} and Gravois,\textsuperscript{239} the court said:

\begin{quote}
[I]n those cases where there is both a partial liquidation and a corporate reorganization, the question becomes a matter of degree . . . . The transaction is to be viewed as a whole and its dominant aspect is to govern the tax character of the expenditure . . . . \\
It appears to the Court from an evaluation of all of the evidence that the motivating and dominant reason for the recited activities was the maintaining of the Caterpillar franchise and its continued value to [the corporation]. If this be so, then the corporate reorganization was effected "for the improvement of a tan-
\end{quote}

\footnotesize{(E.D.S.C. 1957), discussed at note 103 \textit{supra}. \textit{But cf.} United States v. Smith, 418 F.2d 589, 596-97 (5th Cir. 1969) (mere threat of receivership not sufficient for deductibility of settlement payment where some question existed as to whether liability for payment was assumed as part of cost of assets acquired; case remanded for determination on assumption question).  
\textsuperscript{234} 71-2 U.S. Tax Cas. 87,870 (C.D. Cal. 1971).  
\textsuperscript{235} Id. at 87,876.  
\textsuperscript{236} 327 F. Supp. 1128 (M.D. Tenn. 1971).  
\textsuperscript{237} Mills Estate, Inc. v. Commissioner, 206 F.2d 244 (2d Cir. 1953).  
\textsuperscript{238} United States v. General Bancshares Corp., 388 F.2d 184 (8th Cir. 1968).  
\textsuperscript{239} Gravois Planing Mill Co. v. Commissioner, 299 F.2d 199 (8th Cir. 1962).}
gible or intangible asset." As such, the expenses therefor would not be deductible as an ordinary and necessary business expense under the holding of *Mills Estate* and the other cases hereinbefore cited.

However, the principle reason that the taxpayer must fail is that it has failed to produce satisfactory evidence to qualify its expenditures as an ordinary and necessary business expense.240

*Hilton* and *Woodward* were not cited, nor was the origin and character test mentioned.

The court's exact meaning in the last paragraph quoted above is difficult to determine. In any event it should be noted that the transaction in *Thompson*, although technically falling under sections 355 and 368, appeared to contain elements of both section 302 and section 346. There was a contraction of the corporate enterprise and apparently a non pro rata distribution. However, rather than holding that the “dominant aspect” of the transaction was share acquisition, recapitalization, or partial liquidation, the court introduced a new element, namely, whether the expense was to protect a capital asset already held by the corporation. In effect the *Thompson* approach is a business purpose approach, though unfortunately for the taxpayer in *Thompson*, that purpose was capital in nature. Thus, *Thompson* might strengthen the argument of a taxpayer who contends that there was a noncapital business purpose for a share redemption. Naturally, this raises some question as to whether the *Thompson* analysis would be consistent with application of the origin and character test. On one hand, since the transaction in *Thompson* had several “characters” (partial liquidation, share acquisition, and recapitalization), it might not be inappropriate to determine the context in which the transaction “arose”. That context might be considered the need to satisfy Caterpillar. On the other hand, quaere whether it is appropriate to consider the transaction as arising in a context other than that of partial liquidation, share acquisition, or recapitalization. In other words, once the several characteristics of the transaction lead to application of the origin portion of the test, perhaps one should be restricted to finding that it “arose” in one of the contexts that gave rise to the transaction’s multi-character quality, rather than permitting the introduction of elements which might otherwise be irrelevant. In any event, *Thompson* should not present any obstacles to the deductibility of expenses in a straight partial liquidation where

no capital asset (e.g., a franchise) appears to have been enhanced as a result of the contraction.

One other case since Hilton relates to the partial liquidation line of authority. In E. I. du Pont de Nemours & Co. v. United States, du Pont and Imperial Chemical Industries (Imperial) each owned 42 percent of the stock of Canadian Industries Limited (Industries). The remaining 16 percent was owned by the public. Pursuant to an antitrust decree, du Pont and Imperial were required to terminate their joint interest in Industries. With several alternatives open under the decree, the parties chose to divide the physical assets of Industries between du Pont and Imperial. This was accomplished as follows: Public ownership of Industries was increased by 10 percent. Then two new corporations were formed as subsidiaries of Industries. Industries distributed half of its assets to one subsidiary and half to the other. Imperial's stock in Industries was redeemed by Industries in exchange for the stock of one of the new subsidiaries. In essence, what occurred was a non pro rata split off of half of the assets of Industries.

Du Pont attempted to deduct the expenses incurred in developing and carrying out this segregation of assets plan. The Third Circuit, in disallowing the deduction, said:

If these legal expenses were incurred in an attempt to defend and preserve the taxpayer's Canadian business enterprise from the assault represented by the government antitrust litigation in New York, they were properly deductible as ordinary and necessary business expense. . . . If, on the other hand, the expenditures fall within the general category of reorganization expenses, they should be capitalized and are not deductible. . . . Gravois Planing Mill Co. v. Commissioner . . . These general principles have recently been reiterated and applied in Woodward v. Commissioner . . . and United States v. Hilton Hotels Corporation . . .

. . . Several options were available to the taxpayer, most of which would have involved a termination of its Canadian business activities. The taxpayer chose instead to set up a new Canadian corporation to retain half of the assets and continue in business. The expense of this reorganization should clearly not be charged against the income of any one year. Rather, the expenditures resulted in a benefit to the taxpayer which could be expected to produce returns for many years in the future.242

The court did not cite United States v. General Bancshares Corp.243

241 432 F.2d 1052 (3d Cir. 1970).
242 Id. at 1058-59.
24388 F.2d 184 (8th Cir. 1968). See text accompanying notes 51-58 supra.
or United States v. Transamerica Corp. However, this may not be too surprising since there appears to have been no corporate contraction in du Pont. Before the transaction, du Pont owned 42 percent of the stock of Industries, and after the transaction du Pont controlled a corporation which held 50 percent of the assets of Industries. To be sure, Industries may have suffered a corporate contraction, but it was du Pont, not Industries, which had paid the expenses and was seeking the deduction. Therefore, du Pont probably does not cut against the implication in General Bancshares and Transamerica that expenses of a straight section 346 transaction would be deductible.

VI. SUMMARY AND CONCLUSION

Prior to the Hilton and Woodward decisions, there were three distinct lines of cases dealing with the deductibility of stock redemption expenses. Under the partial liquidation line, the expenses were deductible if the dominant aspect of the transaction was determined to be partial liquidation as opposed to reorganization. Under the simple acquisition line, the expenses were not deductible under any circumstances. Under the business purpose line, they were deductible if a noncapital business purpose for the transaction could be shown. The cases in the simple acquisition line could be reconciled with the more recent cases in the partial liquidation line under the rationale that expenses of a section 346 type of transaction were deductible, while expenses of a section 302 type of transaction were not. The business purpose line could then be regarded as adding an exception; if in a section 302 type of transaction a showing of strong noncapital business purpose could be made, the deduction would be allowed.

This prior law may be unaffected by the Hilton and Woodward decisions. First, the expenses in Hilton might have been viewed by the Court as expenses of the merger, although there are strong indications to the contrary. Second, the expenses might have been viewed as connected with the purchase by one corporation of the stock of another, and here there are mixed indications of such a view. But even if Hilton were viewed by the Court as the purchase by a corporation of its own stock, the prior law may remain substantially intact. Under the origin and character test (with the

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244 392 F.2d 522 (9th Cir. 1968). See text accompanying notes 59-61 supra.
245 See text accompanying notes 51-61 supra.
emphasis on character) a section 346 transaction would contain few if any elements of share acquisition or recapitalization. Thus, in such a case the presumption would be in favor of allowing a deduction. The presumption might be overcome by showing a strong capital business purpose for the transaction, although the survival of the business purpose rationale is somewhat questionable. On the other hand, expenses of a section 302 type of transaction should presumptively not be deductible after Hilton. Again, the presumption might be overcome by a showing of strong noncapital business purpose. Finally, expenses of a mixed transaction might be measured on the basis of the context in which the transaction arose. In any event, application of the single test of Hilton and Woodward will hopefully bring some order out of the chaos characteristic of this area of the law.
# APPENDIX A

<table>
<thead>
<tr>
<th>Date</th>
<th>Case or Ruling</th>
<th>Service or Court</th>
<th>Judge</th>
<th>Type of Property Distributed</th>
<th>Type of Case</th>
<th>Code Decided Under</th>
<th>Pro Rata Distribution</th>
<th>Held For</th>
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<td>Office Decision 852</td>
<td>Service</td>
<td>Tyson</td>
<td>unspecified</td>
<td>simple acquisition</td>
<td>1918</td>
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<td>1939</td>
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<td>1939</td>
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<td>Blackmun</td>
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