Stock Redemptions through the Use of Controlled Corporations: Why Haserot Was Wrong

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Both sections 304 and 351 of the Internal Revenue Code may arguably be said to govern certain transfers of stock in controlled corporations even though the tax consequences can vary considerably depending upon which section is held to cover the transaction. After examining the arguments which have attempted to resolve this apparent conflict, the author suggests that a careful reading of the Code and its legislative history demonstrates that there is in fact no conflict between sections 304 and 351, and that section 304 is the principal governing provision in such transactions.

For well over a decade, courts and commentators have struggled with an apparent conflict between sections 3041 and 3512 of the Internal Revenue Code. Under essentially identical facts, taxpayers transferring stock in one corporation to a related corporation3 in exchange for stock and cash in the second corporation, have received different treatment. Where section 304 was said to control the transfer, the amount taxable on the transaction was treated as ordinary income; where section 351 was said to control, the taxable gain was treated as capital gain.

Arguments advanced to resolve this "conflict" between the two sections have thus far been generally inconclusive. It is the purpose of this article to demonstrate that, in fact, no genuine conflict exists, and that the statutory scheme, as evidenced by the legislative history of section 351, clearly indicates that section 304 is the primary and predominant section to be applied in such transactions.4

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1. I.R.C. § 304.
2. Id. § 351.
3. Related corporations in terms of § 304 are either parent-subsidiary or brother-sister corporations. Parent-subsidiaries exist where one corporation owns 50% or more of another. Id. § 304(a)(2). Brother-sister corporations exist when there is common control through 50% or more ownership of two corporations. Id. § 304(a)(1).
4. The controversy has centered, for the most part, around the cash involved in such transactions, and the analysis herein is directed primarily to that aspect of the problem. See note 61 infra.
I. COVERAGE OF THE SECTIONS

Section 304(a)(1) of the Code provides that if "one or more persons are in control\(^5\) of each of two corporations, and . . . in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control" then, for the purpose of applying section 302,\(^6\) the stock shall be treated as having been redeemed by the corporation making the acquisition.\(^7\) The purpose of the provision is to prevent the bailout of corporate earnings by the device of having brother-sister corporations purchase each other's stock from controlling shareholders.\(^8\)

To illustrate the application of the section, assume A owns all of the stock of Corporations X and Y, and X purchases stock from A in Y. Under section 304, the purchase price will be treated as a distribution in redemption of the stock of Corporation X. The redemption will then be tested under section 302 by reference to the stock of Corporation Y (since this is the only stock the ownership of which is changing.

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\(^5\) For purposes of § 304, "control" is defined as "the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock." I.R.C. § 304(c)(1).

\(^6\) I.R.C. § 302. Section 302 provides that a corporate redemption of stock can qualify for exchange treatment instead of § 301 treatment (usually ordinary income treatment) if any one of the tests of § 302(b) are met. The three main tests of subsection (b) are contained in (b)(1), (b)(2), and (b)(3). For convenience, they are often applied in reverse order. Subsection (b)(3) provides exchange treatment for a redemption of a shareholder's stock if that shareholder's interest in the corporation is completely terminated. Subsection (b)(2) provides exchange treatment if the redemption is "substantially disproportionate," which generally means that after the redemption the shareholder must own less than 50% of the voting power of the corporation and must have suffered a more than 20% decrease in his voting power as a result of the redemption. Subsection (b)(1) provides exchange treatment "if the redemption is not essentially equivalent to a dividend." To qualify under (b)(1) a shareholder must have a "meaningful reduction of [his] proportionate interest in the corporation." United States v. Davis, 397 U.S. 301, 313 (1970). If a redemption meets any one of the § 302(b) tests, it qualifies for exchange treatment even though it may fail to meet the other tests. I.R.C. § 302(b)(5).

\(^7\) I.R.C. § 304(a)(1).

\(^8\) But for § 304, a shareholder controlling two corporations could take cash out of one of them by selling to that corporation the stock in the other. Since the transaction would amount to the sale of a capital asset, the shareholder would be entitled to capital gain treatment. He would thus be able to receive corporate earnings at favorable rates without losing control of either of the two corporations. Despite the vehement objection of the Commissioner, prior to the 1954 Code such bailouts were held to be successful. E.g., Commissioner v. Pope, 239 F.2d 881 (1st Cir. 1957); see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 9.30 (3d ed. 1971).
In the case posited, A would not meet the tests of section 302, and the redemption would therefore be treated as a distribution under section 301 rather than as a sale or exchange of stock. Assuming adequate earnings and profits in Corporation X, the transaction would produce ordinary income to A in the full amount of the purchase price.

Section 351 of the Code deals with transfers of property to controlled corporations. It provides that "[n]o gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control of the corporation." Section 351(b) then goes on to provide that if there is property (boot) other than stock or securities in the transaction, gain will be recognized, but not in excess of the amount of the boot. Section 351(b), therefore, taxes the lesser of the boot or the gain.


9. I.R.C. § 304(b)(1). The corporation distributing the cash in exchange for the stock is referred to in the statute as the "acquiring corporation." The corporation whose stock is being transferred is called the "issuing corporation."

10. A can meet neither the § 302(b)(3) test of complete termination of his interest in X nor the § 302(b)(2) test of a substantially disproportionate redemption. This is true no matter how much of his Y stock is purchased by X, because X's ownership of Y stock is attributed to A under § 318(a)(2)(C). Therefore, by application of that section, A owns one hundred percent of X both before and after the transactions. (Section 318 attribution rules apply to § 302 by virtue of § 302(c)(1)).

A also fails to meet the "not essentially equivalent to a dividend" test of § 302(b)(1), since after attribution there is no reduction of his interest. See note 6 supra.


12. The distribution is treated as ordinary income only if it is a dividend. I.R.C. § 301(c). Section 316(a) provides that: "[T]he term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or (2) out of its earnings and profits of the [current] taxable year . . . ." Section 304(b)(2)(A) states that in a § 304(a)(1) distribution, it is the earnings and profits of the acquiring corporation which control. Therefore, if X, the acquiring corporation, has sufficient earnings and profits, current or accumulated, the distribution to A is a dividend in toto and included in gross income under § 301(c).

13. For purposes of § 351 "control" is defined in § 368(c) as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." Cf. note 5 supra (defining § 304 "control").


15. Id. § 351(b). Section 351(b) furnishes a way back into § 351 for taxpayers who do not receive solely stock and securities as subsection (a) requires. But the price of re-entry is recognition of the lesser of (1) the gain realized or (2) the amount of money received plus the fair market value of any other property received. In the § 351 context
The purpose of section 351 is to avoid levying a tax on mere changes in the form of an investment.\textsuperscript{16} It is normally thought of as covering original incorporation transactions, but it also applies to post-incorporation transfers, provided the control test is met.\textsuperscript{17} To illustrate: if \( A \) owns 70\% of Corporation \( X \) and transfers property to Corporation \( X \) in exchange for an additional 10\% stock interest, plus cash, section 351 would cover the transaction and only the lesser of the gain or the boot (cash) would be recognized and taxed. If the property transferred were a capital asset held by \( A \) for more than a year, the gain would be long-term capital gain.\textsuperscript{18}

II. THE "Conflict"

The application of sections 304 and 351 is probably clear enough so long as each operates within its particular sphere. However, cases have arisen which appear to fall under both sections, and, therefore, seem to involve a direct conflict between them.\textsuperscript{19} In its most simple form the typical situation is as follows: \( A \) owns 100\% of the stock of Corporations \( X \) and \( Y \). \( A \) transfers some or all of the stock in \( X \) to \( Y \) in exchange for additional stock in \( Y \) and some cash. Assume that the \( X \) stock which is transferred has a basis of 100 and a fair market value of 200 and assume further that \( A \) receives stock in \( Y \) worth 50 plus cash of 150. Under these circumstances, it appears that the transaction falls under section 304\textsuperscript{20} and that the cash of 150 is to be treated as a
distribution in redemption of the stock of $Y$. Since $A$ cannot meet any of the tests of section 302(b), as applied to his Corporation $X$ stock interest, the cash becomes a section 301 distribution, and the result (assuming adequate earnings and profits in $Y$) is ordinary income to $A$ in the amount of 150. However, the transaction also appears to fall under section 351. Immediately after the transaction, $A$ controls Corporation $Y$ and has transferred to $Y$ property (stock in $X$) for $Y$ stock and boot (the cash). As a result, under section 351(b) taxable gain is limited to the lower of the gain (100) or the boot (150). Further, since the stock transferred is a capital asset held for more than one year, the gain is long-term capital gain.

III. THE AUTHORITIES

Naturally, the taxpayer would prefer to have section 351 treatment, and in the first presentation to the courts of the general fact pattern discussed above, the taxpayer succeeded in convincing the Tax Court, in *Henry McK. Haserot*, and the Sixth Circuit, in *Commis-*

22. Applying § 304(b) mandates the application of the § 302(b) tests, see note 6 supra, to the issuing corporation’s ($X$’s) stock. See note 9 supra. $A$ cannot meet the § 302(b)(3) or (b)(2) tests with respect to his $X$ stock because ownership of $X$ stock is attributed to him from corporation $Y$ which he wholly owns. I.R.C. § 318(a)(2)(C). See note 10 supra. $A$, therefore, has not had a complete termination of his interest in $X$ nor a substantially disproportionate redemption. Furthermore, $A$ does not meet the § 302(b)(1) test since there is no “meaningful reduction of [his] proportionate interest” in $X$ due to attribution to him of the $X$ stock through $Y$. See notes 6, 10 supra.
23. I.R.C. § 302(d); id. § 301(a), (c).
24. See note 13 supra and accompanying text.
25. I.R.C. § 351(b); see notes 13–15 supra and accompanying text.
26. See note 15 supra and accompanying text.
27. I.R.C. § 1222(3).
29. 41 T.C. 562 (1964). In the *Haserot* litigation, see note 19 supra, the facts were essentially as follows. Before the transactions in question, the petitioner-taxpayer owned a controlling stock interest in three corporations: Northport, Gypsum, and Haserot (referred to by the court as “Company”). Company and Gypsum were controlled by petitioner directly. Company in turn owned most of the remaining stock of Gypsum and some of the remaining stock of Northport. The balance of the Northport stock was owned by Gypsum. Petitioner transferred his entire stock interests in Northport and Gypsum to Company for additional Company stock and a cash credit to his account with Company. The Tax Court summarized the changes in stock ownership as follows:

Before the transactions, the ownership of the corporations was . . .

Northport (4,562 shares): Petitioner, 1,999; Gypsum, 1,312; Company, 1,250; others, 1.
Gypsum (6,582 shares): Petitioner, 4,486; Company 2,022; others, 74.
Company (33,014 shares): Petitioner, 18,895; petitioner’s son, 1,023; estate of
sioner v. Stickney, 30 that where both sections appear to govern, section 351 controls.31 Subsequently, the Ninth Circuit took the opposite
petitioner’s father, 10,293; others, 2,803.
Ater the transactions, the ownership was as follows:
Northport (4,562 shares): Company, 3,249; Gypsum, 1,312; others, 1.
Gypsum (6,582 shares): Company, 6,508; others, 74.
Company (35,446 shares): Petitioner, 29,188; petitioner’s son, 3,455; others
2,803.
If we look only to the shares registered in petitioner’s name, his percentage
of control is as follows:

<table>
<thead>
<tr>
<th></th>
<th>Northport</th>
<th>Gypsum</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before</td>
<td>43.8</td>
<td>68.2</td>
<td>57.2</td>
</tr>
<tr>
<td>After</td>
<td>0</td>
<td>0</td>
<td>82.3</td>
</tr>
</tbody>
</table>

However, the Company owned shares in both Gypsum and Northport. A
majority of the issued and outstanding shares of the Company were registered
in petitioner’s name and he therefore could dictate actions to be taken by
Company with respect to its Northport and Gypsum shares. As a result,
petitioner had effective control of a majority of the shares of all three corpora-
tions, as revealed by the following table:

<table>
<thead>
<tr>
<th></th>
<th>Northport</th>
<th>Gypsum</th>
<th>Company</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before</td>
<td>99.9</td>
<td>98.9</td>
<td>57.2</td>
</tr>
<tr>
<td>After</td>
<td>99.9</td>
<td>98.9</td>
<td>82.3</td>
</tr>
</tbody>
</table>

Finally, if we apply the attribution rules of section 318, the following pattern
of petitioner’s control appears:

<table>
<thead>
<tr>
<th></th>
<th>Company</th>
<th>Gypsum</th>
<th>Northport</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before</td>
<td>91.5</td>
<td>96.3</td>
<td>96.6</td>
</tr>
<tr>
<td>After</td>
<td>92.1</td>
<td>91.1</td>
<td>91.8</td>
</tr>
</tbody>
</table>


The Commissioner argued that § 304 applied to the transaction because petitioner
controlled (as defined in § 304(c)) Northport, Gypsum, and Company, and transferred
stock in the first two to Company for property. The taxpayer, on the other hand,
contended that § 351 governed because he had transferred property (the Northport and
Gypsum stock) to a corporation (Company) in exchange for stock and cash and was in
control of the transferee corporation immediately after the transfer.

30. 399 F.2d 828 (6th Cir. 1968) (Stickney was Haserot’s executor and a substitute
party on appeal).

31. In the first trial before the Tax Court it was held that § 351 governed the
transaction. Henry McK. Haserot, 41 T.C. 562 (1964). On appeal, the Sixth Circuit did
not decide which section controlled but remanded for a determination of whether the
transaction was essentially equivalent to a dividend within the meaning of § 302(b).
Commissioner v. Haserot, 355 F.2d 200 (6th Cir. 1965). The Tax Court then decided this
issue in the affirmative but refused to reconsider its earlier decision as to the applicabil-
ity of § 304. Henry McK. Haserot, 46 T.C. 864 (1966). In a separate opinion, Judge
Tannenwald, who was joined by Judge Simpson, dissented from the court’s decision not
to reconsider and stated that he felt that § 304 controlled. Id. at 872–78. However, the
Sixth Circuit finally agreed with the majority of the Tax Court and held that § 351
governed. Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968). This was a somewhat
surprising result, for if § 351 controlled all along, then whether the distribution was
essentially equivalent to a dividend under § 302 was irrelevant, and there should not have
been a remand in the first place.
position in *Rose Ann Coates Trust v. Commissioner* and held that section 304 is predominant.

As might be expected, there have been several articles on the subject. Some commentators have pointed out the bailout possibilities available under section 351 in the related corporation setting. Others have approached the problem from a policy standpoint and have suggested compromise solutions. A few have claimed that the conflict between the sections is irreconcilable on the face of the statute and have called for a legislative response to the dilemma. It is the position of this writer, however, that a simple understanding of the statutory scheme, as evidenced by the legislative history of section 351, will lead to the conclusion that there is no conflict between the

32. 480 F.2d 468 (9th Cir.), *cert. denied*, 414 U.S. 1045 (1973), *aff’d* 55 T.C. 501 (1970). The Coates family group owned all of the stock of two corporations, CAM Industries and Washington Industrial Products (WIP). The family attempted to merge the two corporations by selling the WIP stock to CAM under an agreement calling for the payment of the purchase price over a ten-year period with four percent annual interest. The Commissioner argued that the family was a group of persons controlling (as defined in § 304(c)) two corporations and transferring stock in one to the other for property (the sale agreements) so that § 304 applied. The taxpayer-trust contended that § 351 applied because property (the WIP stock) had been transferred for “securities” (the sale agreements) to CAM, which was controlled by the taxpayer and others in the transferring group, immediately after the transfer. The Tax Court avoided the problem by holding § 351 inapplicable because no non-recognition property (stock or securities) had been received. Rose Ann Coates Trust v. Commissioner, 55 T.C. 501 (1970). The Ninth Circuit, however, squarely faced the issue and stated that § 304 overrides § 351. Rose Ann Coates Trust v. Commissioner, 480 F.2d 468 (9th Cir. 1973).


35. See, e.g., Kempf, *Section 304 of the Internal Revenue Code: Unmasking Disguised Dividends in Related Corporation Transactions*, 33 U. CHI. L. REV. 60, 80–81 (1965); 12 DUQ. L. REV. 678, 687 (1974); cf. Marans, *Section 304: The Shadowy World of Redemptions Through Related Corporations, supra* note 34, at 191–92, 216–19 (espousing the necessity for a legislative response, but also offering a § 304–351 combination approach as an alternative to a re-working of the Internal Revenue Code); Note, *Conversion of Brother-Sister Corporations Into a Parent-Subsidiary Relationship—A Legitimate Tax-Saving Device or an Unwanted Dividend?*, 5 MEM. ST. L. REV. 31, 39–40 & n.59 (1974) (favoring the resolution of the conflict adopted by the Sixth Circuit Court of Appeals in Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968), and proposing an amendment to §§ 351 and 302(d) which would require § 304 to yield to § 351 when a transaction falls within the purview of both sections).
two sections, and that with respect to any cash involved in such transactions, section 304 must prevail over section 351.

IV. THE ARGUMENTS

In order to put the problem in perspective, however, it might be appropriate to review, briefly, the arguments raised thus far. They run along the following lines:

First, for the taxpayer, it is pointed out that section 304 refers to a transfer of stock in return for property, and that for purposes of section 304, the term "property" as defined in section 317(a) specifically excludes "stock in the corporation making the distribution . . . ." Therefore, the inclusion of stock in the transaction prevents section 304 from operating.

The answer to this line of analysis, as pointed out by Judge Tannenwald, in his separate opinion in Henry McK. Haserot, is that section 304 does not say "solely in return for property," and that Congress knows how to use the word "solely" when this is its intention. Furthermore, the exclusion of stock from the definition of property in section 317(a) might simply mean that the stock in a Haserot-type transaction is to be ignored, with the result that only the cash received by the shareholder would be taxed, a limitation the government was ready to accept in the original Haserot case itself.

36. The same principle would apply to any other § 317 property. See text accompanying notes 37–39 infra.


38. Section 317(a) provides: "[T]he term 'property' means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution . . . ."


40. Id. at 874–75.

41. Id.

42. Henry McK. Haserot, 41 T.C. 562, 569 (1964). An argument apparently related to the § 317 "property" argument is based upon the notion that § 304 applies only to sales ("sale" meaning a transfer for cash or its equivalent), whereas § 351 applies to both sales and exchanges ("exchange" referring to a transfer for property other than cash or its equivalent). This argument appears to be based upon the use of the term "sales" in the legislative history under § 304 rather than upon the phrase "sales or exchanges." Henry McK. Haserot, 46 T.C. 864, 874 (1966); Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 188. The transaction at issue in Haserot would be an exchange under this analysis, since both cash and stock were received; therefore, only § 351 would apply to the transaction. See Commissioner v. Stickney, 399 F.2d 828, 834 (6th Cir. 1968); Henry McK. Haserot, 46 T.C. at 873–74 (Tannenwald, J., separate opinion); Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 188–89.

The answer to this line of reasoning is that in using the terms "sell" and "sold" Congress was not drawing a distinction between "sale" and "exchange" but was simply
A second major argument supporting the taxpayer's position centers on the dependence of section 304 on sections 301 and 302 and the "except as otherwise provided" language contained in sections 301 and 302. Section 301(a) begins with the language, "Except as otherwise provided in this chapter . . ."; similarly, section 302(d) begins, "Except as otherwise provided in this subchapter . . .". Sections 301, 302, 304, and 351 are all in the same chapter, 1, and subchapter, C. However, section 351 does not contain any "except as otherwise provided" language. Therefore, since sections 301 and 302 contain this limitation while section 351 does not, and since 304 is dependent upon sections 301 and 302 through sections 304(a) and (b), sections 301, 302, and 304 must yield to section 351 when both sections 304 and 351 are applicable to the same set of facts.  

A response to this argument, and that offered by most commentators, is that the "except as otherwise provided" language in sec-

using the terms as a short-hand way of describing the type of transaction involved. This phraseology, therefore, is simply too slender a reed upon which to base such a major decision of substantive law. Henry McK. Haserot, 46 T.C. at 874; Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 189 n.114; see H.R. Rep. No. 2319, 81st Cong., 2d Sess. 53 (1950). Furthermore, "sale" is not referred to in § 304 itself; § 304 refers to "acquisition," a term which encompasses a broader spectrum of transactions than the term "sale." Henry McK. Haserot, 46 T.C. at 874; Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 189 n.114; see H.R. Rep. No. 1337, 83d Cong., 2d Sess. A79, reprinted in [1954] U.S. Code Cong. & Ad. News 4017, 4216 (where the language of the House version of § 304(a) was "proceeds of such sale"). Finally, no reason appears why a "sale," i.e., an exchange for cash or its equivalent, ought to be treated differently from any other exchange. But see Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 188-89.

43. The full sentence reads: "Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)." I.R.C. § 301(a).

44. The full sentence reads: "Except as otherwise provided in this subchapter, if a corporation redeems its stock (within the meaning of section 317(b)), and if subsection (a) of this section does not apply, such redemption shall be treated as a distribution of property to which section 301 applies." I.R.C. § 302(d).

45. This analysis was the basis of the Tax Court's original holding in Henry McK. Haserot, 41 T.C. 562, 570 (1964), subsequently affirmed by the Sixth Circuit in Commissioner v. Stickney, 399 F.2d 828, 834-35 (6th Cir. 1968).

46. See, e.g., Kempf, supra note 35, at 70-73; Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 186. But see Note, Section 351 Precludes Dividend Treatment of "Boot" Paid in a Section 304 Redemption of Broker-Corporation Stock Even When the "Boot" is Essentially Equivalent to a Dividend, 45 Tex. L. Rev. 771, 775 (1967). See also Henry McK. Haserot, 46 T.C. 864, 875-78 (1966) (Tannenwald, J., separate opinion).

The position taken by these authorities is also defended by the Commissioner: The "except" clause in § 302(d) was meant to follow the words "such redemption" in that
tions 301 and 302 is in the statute to accommodate other redemption and distribution sections, such as 303, 331, and 346, but that this language does not go so far as to accommodate section 351.

Next, for the taxpayer, there is offered what might be called the "lazy person's view of the statute." Section 351 is simple to read and easy to understand and by its terms applies to the transaction in a fairly straightforward manner. The application of section 304, on the other hand, depends upon the applicability of a host of related sections (such as sections 301, 302, and 318), many of which are quite complicated. Therefore, in the interest of judicial economy, where both sections apply to the same transaction, section 351 should be held to control.

Lest one answer this line of reasoning by suggesting that it is absurd on its face, it should be noted that the Sixth Circuit's opinion in Commissioner v. Stickney contains language coming quite close to this analysis.

Then, on the government's behalf, one of the strongest arguments is the absurdity-of-result analysis. No statute should be interpreted so as to create an absurd result, and under the Sixth Circuit's decision in the Haserot litigation, absurdity is the order of the day. On the Haserot facts, with section 351 controlling, a shareholder who ends up with

section and to accommodate only other redemption sections. The "except" clause in § 301(a) was meant to follow the words "a distribution" in that section and to accommodate only other distribution sections. Therefore, these clauses do not accommodate § 351, which is neither a redemption nor a distribution section. Kempf characterizes the Commissioner's position as a middle ground between the taxpayer's argument that the "except" clauses are all-inclusive in accommodating every section in subchapter C (referring to the "except as otherwise provided in this subchapter" language of § 302(d)) or in chapter 1 (referring to the "except as otherwise provided in this chapter" language of § 301(a)), including § 351, and the argument that the "except" clauses only accommodate those Code sections which explicitly refer to §§ 301 and/or 302 (i.e., §§ 331(b) and 346(c)). Kempf, supra note 35, at 71.

47. Of course, § 301 also accommodates § 302.

48. Section 303 provides exchange treatment for distributions in redemption of stock to pay administrative, funeral, and estate tax expenses. Sections 331 and 346 provide exchange treatment for distributions in complete or partial liquidation. I.R.C. §§ 303, 331, 346.

49. A comparison of . . . Section 351 and the facts clearly demonstrates the applicability of § 351. In marked contrast, if Section 304(a) also applies, that can only be determined by laboring through a labyrinth of related sections. Section 304 is not self-executing in any sense, and where it has application the tax liability can only be determined by reading other sections in pari materia.

399 F.2d at 834.


51. See note 29 supra.
more than 80% of the stock of the acquiring corporation will receive
sale-or-exchange treatment by virtue of section 351;52 one who ends up
with less than 50% will get sale-or-exchange treatment by virtue of the
inapplicability of section 304;53 but one who ends up with between
50% and 80% may be saddled with ordinary income treatment by
virtue of section 304.54 Thus, shareholders who have very little
common control and those possessing a great deal of common control
will all receive capital gain treatment while those in between will
receive ordinary income treatment. To avoid this, the argument goes,
the statute should be interpreted so that section 304 controls.

Finally, for the government, several additional reasons are offered
for treating section 304 as predominant. First, since section 304 is
more recent legislation than section 351 (when predecessor sections
are taken into account), section 304 expresses current legislative in-
tent.55 Second, section 304 should prevail because it is more specific in
its treatment of related corporations.56 Third, analogous cases indicate
that "section 351 will give way when its literal application tends to
frustrate another section of the Code."57 Last, it is contended that the
transaction in question is more like the "narrow group" of transactions
covered by section 304 than the "broad range"58 of transactions
covered by section 351.59

52. See notes 14–18 supra and accompanying text.
53. See note 5 supra and accompanying text. When a taxpayer is outside § 304, he
generally receives capital gain tax treatment for the sale of his stock under §§ 1001, 1221,
and 1222. See note 8 supra.
54. He possesses sufficient control under § 304(c) to trigger the operation of § 304,
but insufficient control under § 368(c) to fall within § 351. See notes 5, 13 supra.
55. See Kempf, supra note 35, at 74. See also Rev. Rul. 73–2, 1973–1 C.B. 171. The
answer here may be that Congress was well aware of the existence of § 351 when it
enacted § 304 and did not indicate that § 304 should predominate.
56. Kempf, supra note 35, at 74; Marans, Section 304: The Shadowy World of
Redemptions Through Related Corporations, supra note 34, at 187; accord, Rev. Rul.
73–2, 1973–1 C.B. 171. The logical response here might be that § 351 is more specific in
its treatment of transfers of property to controlled corporations.
57. Kempf, supra note 35, at 74 (citing National Sec. Corp. v. Commissioner, 137
F.2d 600 (3d Cir.), cert. denied, 320 U.S. 794 (1973), and Rooney v. United States, 305
F.2d 681 (9th Cir. 1962), both concerning a conflict between §§ 351 and 482, or the
59. One additional argument has been advanced to resolve the supposed conflict
between §§ 304 and 351. In the original Tax Court proceeding in the Haserot litigation,
the taxpayer sought to bolster the argument that the § 301(a) "except" language accom-
modated § 351 by citing the cross reference to § 351 in the predecessor of § 301(e)(3). The
Commissioner quickly responded that § 7806(a) states that cross references between
Code sections shall be given no legal effect. However, the Commissioner too seemed to
be straining when he suggested that § 7806(a) also applied to the "except" clauses in §§
301(a) and 302(d). Kempf, supra note 35, at 69.
Unfortunately, the arguments outlined above have been generally inconclusive. It might, therefore, be better to try a different approach and concentrate on the language of section 351 rather than on that of section 304 and its related sections.

As previously noted, section 351 provides that when boot is received upon a transfer to a controlled corporation, gain is recognized to the extent of the boot. But it is of some interest that nowhere in section 351 itself does the statute describe how that gain is to be treated—whether as ordinary income or as capital gain. It has been suggested, therefore, that perhaps the amount of taxable income (the gain) could be determined under section 351, while the treatment of that income could be determined under sections 301 through 304. Thus, returning to the case posited earlier, assume that A, owning 100% of Corporations X and Y, transfers to Y some of his X stock with a fair market value of 200 and a basis of 100, in exchange for Y stock worth 50 and cash of 150. The amount of gain realized would be the difference between the amount realized (200) and the adjusted basis (100), and the gain recognized would be the lesser (100) of the gain realized (100) or the boot (150). But the treatment of that gain would be determined under section 304. The result would, therefore, be ordinary income of 100, as opposed to ordinary income of 150 had the transaction been treated solely under section 304.

60. I.R.C. § 351(b); see note 15 supra and accompanying text.
61. This § 304-351 combination approach was discussed, but rejected, by Marans. Marans, Section 304: The Shadowy World Revisited, supra note 34, at 722–23. Instead, Marans favored having the stock received by the controlling shareholder from the acquiring corporation treated under § 351 while the § 317 property is treated under § 304 and its related sections. Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 191–96. This latter treatment is in accord with the current position of the Internal Revenue Service. See Rev. Rul. 73–2, 1973–1 C.B. 171. It appears to depend, however, on § 304 being held to be predominant over § 351 and, therefore, begs the essential question. Indeed, once it is determined that § 304 governs with respect to § 317 property, it makes little difference to either the government or the taxpayer under what section the stock is treated, since both generally would agree that receipt of the stock is a non-recognition transaction.

Marans has also suggested the possibility of applying § 301 “roughshod” to the § 351 boot and ignoring §§ 302 and 304. Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 194–95. However, as Marans himself notes: “Congress specifically omitted from section 351 of the 1954 Code even a cross reference to section 301.” Id. at 187 & n.103. Furthermore, it has been suggested that since Congress specifically provided for dividend treatment of boot in § 356, a provision analogous to § 351, it may well have intended that § 351 boot not receive any type of dividend treatment. 64 Colum. L. Rev. 1151, 1154 & n.29 (1964).
62. See text accompanying notes 19–20 supra.
63. I.R.C. § 351(b); see note 15 supra and accompanying text.
64. See text accompanying notes 20–23 supra.
SECTIONS 304 AND 351

The problem with this approach, the taxpayer will argue, is that the sale of a capital asset, the X stock, receives ordinary income treatment in apparent contradiction of the sale-or-exchange sections, which dictate that gain realized on the sale of a capital asset shall be treated as a capital gain. The government's answer is likely to be that section 304 precludes sale-or-exchange treatment unless the transaction can pass the tests of section 302(b). The taxpayer will no doubt then fall back upon the "except as otherwise provided" language, pointing out that the sale-or-exchange sections are in the same chapter as section 301. Therefore, even with respect to the treatment of the recognized gain, sections 301 and 304 must yield to other sections, in this case the sale-or-exchange sections, and, thus, the analysis has come full circle.

Or has it?

If in fact the "except as otherwise provided" language of section 301(a) forces section 304 to yield to the sale-or-exchange sections in this case, then section 304 will never operate in any case. Since every redemption through related corporations is ostensibly a sale, the sale-or-exchange sections would always govern. Thus, a literal reading and application of the "except as otherwise provided" language in section 301 would effectively eliminate sections 301, 302, 303, 304, 331, and 346 from the Code.

For this reason the sale-or-exchange sections must yield to section 304 in this case, and indeed in every case of redemptions through related corporations. Carrying this analysis one step further, however, it becomes clear that section 351 should not be involved in the Haserot problem at all, at least insofar as the transaction includes section 317(a) property. Section 351 does not operate in a vacuum. Instead, section 351 is a non-recognition provision, the sole function of which is to operate as an exception to the general rule of the sale-or-exchange sections. This limited role of section 351 is made clear by its legislative history. In the 1939 Code, the predecessors to section 1001(c) and

65. I.R.C. §§ 1001-24, 1201-54 [hereinafter referred to as the "sale-or-exchange sections"].
66. Sections 1001(a) and 1001(c) are the general Code provisions for the computation and recognition of gain or loss from the sale or other disposition of property. Sections 1201 through 1254 provide that the gain so recognized may be taxed at favorable capital gains rates if the property sold is a capital asset. I.R.C. §§ 1001(a), (c), 1201-54.
67. See note 6 supra.
68. See notes 43-45 supra and accompanying text.
69. See Brief for Appellant at 20, Commissioner v. Stickney, 399 F.2d 828 (6th Cir. 1968).
70. See note 8 supra and accompanying text.
71. The stock could still be treated under § 351. See note 61 supra.
section 351 were contained in the same section, namely section 112, which read as follows:

(a) **General Rule.**—Upon the sale or exchange of property the entire amount of gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b)(5) **Transfer to Corporation Controlled by Transferor.**—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange, such person or persons are in control of the corporation. . . .

When the 1954 Code was adopted, section 112 was split into numerous other sections. The general rule of section 112(a) was placed in section 1002 (which became section 1001(c) in the Tax Reform Act of 1976). The rules of section 112(b) through (n) were placed in sections 351 through 368, as well as other sections. However, the language of section 112(a) remained substantially unchanged, as did much of the language of sections 112(b) through (n).

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74. The Tax Reform Act of 1976 merely moved § 1002 to § 1001(c), which previously had contained a cross reference to § 1002; no substantive change was made. Pub. L. No. 94-455, §§ 1901(a)(121), 1901(b)(28), 90 Stat. 1784, 1799.


change made in section 112(a) was to replace the language "except as hereinafter provided in this section" with the language "except as otherwise provided in this subtitle." This was obviously done to accommodate the placement of sections 112(b) through (n) in sections 317 through 368 and other sections scattered throughout subtitle A. Congress did not, however, intend this revision of the Code to expand the function of sections 112(b) through (n) beyond that of operating simply as exceptions to the general rule of section 112(a). Indeed, the House Ways and Means Committee report states, "Section 351 corresponds in general to section 112(b)(5) of the 1939 Code. No change in present law is intended by your committee as respects the basic purpose of this section."79

The point here is that just as one could not reach section 112(b)(5) (the exception to the sale-or-exchange rule for transfers to controlled corporations), under the 1939 Code, without first being subject to section 112(a) (the basic sale-or-exchange provision), so one cannot reach section 351 today without first being subject to the sale-or-exchange sections. And when dealing with a redemption through related corporations, one never reaches the sale-or-exchange sections unless the transaction is subject to characterization as a sale or exchange under the tests of sections 302 and 304. In other words, section 351 provides that certain sales or exchanges are tax-free, or only taxed in part, but in the related corporation stock purchase situation, at least insofar as the section 317 "property" portion of the transaction is concerned, there is no sale or exchange in the first place unless the tests of sections 302 and 304 are met.80


Earlier versions of the Internal Revenue Code followed the same statutory scheme as that of the 1939 Code: § 351 predecessors were exceptions to § 1001(c) predecessors. Therefore, it is quite likely that when Congress rearranged the Code in 1954, but declared that it intended "no change" in the "basic purpose" of §§ 351 and 1002, it wished to maintain the traditional relationship between the two sections. This relationship dates back to the Revenue Act of 1921 in which § 202(c) followed the pattern of setting out the § 1001(c) predecessor in its first paragraph and the § 351 exception in its subsection (3). Rev. Act of 1921, ch. 136, § 202(c), 42 Stat. 227, reprinted in J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938–1861, at 789 (1938). Section 203 of the 1924 Act continued the same pattern, § 203(a) being the predecessor of present § 1001(c), and § 203(b)(4) being the exception and predecessor to present § 351. Rev. Act of 1924, ch. 234, § 203, 43 Stat. 253, reprinted in J. SEIDMAN, supra at 687, 690. In commenting on the 1924 arrangement, the House Ways and Means Committee declared: "It appears best to provide generally that gain or loss is recognized from all exchanges and then except specifically and in definite terms those cases of exchange in which it is not desired to tax the gain or allow the loss." H.R. REP. No. 179, 68th Cong., 1st Sess. 13 (1924) (emphasis added); see J. SEIDMAN, supra at 687.

80. An argument along the same lines as that discussed in the text was presented to
VI. CONCLUSION

As the legislative history indicates, the statutory scheme of the Code requires, as a first step, the application of sections 302 and 304 to any property distribution of a corporation to a shareholder to determine if that which appears to be a sale or exchange of his stock is to be so treated in fact. If the tests of these sections can be met, then the sale-or-exchange provisions come into play to give the taxpayer long-term capital gain instead of ordinary income. Finally, as an exception to the sale-or-exchange sections, there are provisions such as section 351 which provide that in certain cases no gain at all need be recognized. The statute thus lays down the general rule of ordinary income for related corporation redemption-type distributions, to which there is an exception for capital gain treatment in certain cases, to which there is a further exception of non-recognition in still more limited cases. To go to the most remote exception (section 351) first and ignore the general rule (sections 302 and 304) is simply not proper statutory construction. Under this statutory scheme there is no real conflict between sections 304 and 351, and if section 351 enters the analysis at all, it does so only after the cash or other section 317 property has been treated under section 304 and consequently sections 302 and 301.81

81. See note 61 supra.

82. One possible response to the argument presented in the text is that if §§ 301 through 304 supersede § 351, they would also supersede the reorganization provisions— §§ 354 through 368, and the dividend section in those provisions, § 356, would be rendered unnecessary. There are two responses to this argument. First, § 356 is slightly older than § 302, and it is possible that when § 302 was enacted, § 356 was retained either through oversight or as a result of an abundance of caution. Section 356(a)(2) first appeared substantially in its present form in § 203(d)(2) of the 1924 Revenue Act. Rev. Act of 1924, ch. 234, § 203(d)(2), 43 Stat. 253, reprinted in J. SEIDMAN, supra note 79, at 693. Section 302 did not appear until § 201(g) of the 1926 Act. Rev. Act of 1926, ch. 27, § 201(g), 44 Stat. 9, reprinted in J. SEIDMAN, supra note 79, at 577. Prior to the 1926 Act, the essentially-equivalent-to-a-dividend test only applied to redemptions of, or redemptions associated with, stock dividends.

Second, §§ 302, 304, and 301 might not cover all distributions made in reorganizations. For example, distributions from the acquiring corporation in a statutory merger to the shareholders of the acquired corporation are arguably outside the scope of §§ 301 and 302, because they are not distributions by a corporation with respect to its own shareholders. Therefore, the function of § 356 is to pick up that transaction. In this regard it is of some interest to note, however, that the Internal Revenue Service's position in the
reorganization area appears to be that § 301 may govern a given distribution before the rest of the transaction is treated under §§ 354-368. See Rev. Rul. 61-156, 1961-2 C.B. 62; Treas. Reg. § 1.301-1 (1) (1955).

One further point bearing mention is that in 1954 the Senate rejected a provision in the House bill, H.R. 8300, 83d Cong., 2d Sess. § 306 (1954), which would have subjected all distributions of property in connection with § 351 and the reorganization provisions to § 301. S. REP. NO. 1622, 83d Cong., 2d Sess. 43, 230, reprinted in [1954] U.S. CODE CONG. & AD. NEWS 4621, 4674, 4867; Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 188 & nn. 109-11. But such a rejection is by no means a rejection of the application of §§ 302 and 304 to § 351 and reorganization-type transactions specifically falling within the terms of §§ 302 and 304. Cf. Marans, Section 304: The Shadowy World of Redemptions Through Related Corporations, supra note 34, at 191 and n.119 (finding this legislative history to be no bar to a § 304-351 combination approach). Indeed, in light of the statutory scheme outlined above, see notes 72-80 supra and accompanying text, the House’s proposal might merely have been considered unnecessary.