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in the brother-sister situation, if one of the corporations can be liquidated and its assets taken over by the stockholders, and if subsequently, in a separate transaction, the *assets* are sold to the other corporation for their fair market value, then the transaction would not be a sale or redemption of stock at all, and the stock redemption provisions would not apply.

XI

CAPITAL GAIN PROBLEMS IN PARTICULAR AREAS (cont'd)

DISPOSITIONS OF CORPORATE STOCK (cont'd)

Richard Katcher

THE SALE, EXCHANGE, OR REDEMPTION OF "HOT STOCK"

A problem facing the shareholders of a closely held corporation is how to withdraw corporate earnings at capital gains rates in order to alleviate the burden of double taxation. One method formerly in use to accomplish this end was known as a "preferred stock bail-out." The shareholders would cause a dividend in preferred stock to be declared on their holdings of common stock. They would then sell the dividend stock, and the sale would not cause any loss in their voting control of the corporation. Even though the dividend stock might thereafter be immediately redeemed by the corporation from the purchaser, such a transaction had been held to result in capital gain to the shareholders at the time of sale.¹

Section 306 was enacted as a part of the Internal Revenue Code of 1954 in an attempt to close this loophole.² Section 306 provides, in general, that the proceeds from the sale or redemption of certain stock (referred to as "section 306 stock") shall be treated either as gain from the sale of property which is not a capital asset or as a distribution of property taxable as a dividend. In other words, ordinary income treatment, rather than capital gains treatment, will attend the disposition of section 306 stock. Such stock is sometimes referred to as "tainted" or "hot" stock.

1. *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953). See also Friedman & Silbert, *Acquisition of Corporate Funds at Capital Gains Rates*, N.Y.U. 12TH INST. ON FED. TAX 215 (1954).

2. S. REP. NO. 1622, 83d Cong., 2d Sess. 46 (1954). See the discussion of the historical background of this problem in Gelbert, *Preferred Stock Bail-Outs Under the New Law*, N.Y.U. 13TH INST. ON FED. TAX 597 (1955).

DEFINITION OF SECTION 306 STOCK

Section 306 stock is defined as stock which meets any one or more of three tests.³

Shares Distributed to Shareholders

(1) Stock is hot if it is received as a dividend distributed to a shareholder, if it is excluded from gross income under section 305, and if it is not common stock issued with respect to common stock.⁴ Accordingly, section 306 stock is generally, but not always, preferred stock of a corporation issued as a dividend by the corporation on its outstanding stock.

Common stock of a corporation issued by the corporation as a dividend on its common stock is not section 306 stock. In view of this fact, taxpayers have attempted to declare dividends on their common stock of stock which is denominated common stock, but which has features not ordinarily found in common stock, in order to achieve bail-out possibilities by circumventing section 306. However, it has been ruled that common stock which has no voting rights and is redeemable at the discretion of the corporation, but which is in all other respects identical to the voting common stock, constitutes section 306 stock.⁵

Section 305 excludes from a shareholder's gross income a dividend distribution of the corporation's stock or rights to acquire its stock,⁶ but excepts from this exclusion a stock dividend which is distributed in discharge of preferred dividends for that taxable year or for the preceding taxable year;⁷ a stock dividend for the latter purpose is taxable to the shareholder. Since such a stock dividend is not excluded from the shareholder's gross income by reason of section 305(a), the stock dividend is not hot stock. There is no need to tax such stock as hot stock since its distribution is treated as a withdrawal of the corporate earnings taxable at ordinary rates. However, since a stock dividend distributed in discharge of preferred dividends for years prior to the current year and the preceding year is excluded from income by section 305, the stock dividend is hot stock even if it is a dividend of common stock.⁸ Where part of the distribution is in payment of the dividends for the current year and the preceding year on preferred stock and part of the distribution is in

3. INT. REV. CODE OF 1954, § 306(c)(1). (Hereinafter cited as §).

4. § 306(c)(1)(A).

5. Rev. Rul. 57-132, 1957-1 CUM. BULL. 115. Furthermore, common stock with respect to which there is a privilege of converting into stock other than common stock (or into property) is not deemed to be common stock. § 306(e)(2).

6. § 305(a).

7. § 305(b)(1).

8. Treas. Reg. § 1.306-3(c). (Hereinafter cited as Reg.).

payment of the dividends for prior years, only that part of the distribution applying to the prior years will be treated as section 306 stock.⁹

Stock Received in a Corporate Reorganization or Separation

(2) Also, stock is section 306 stock if it is not common stock and if it is received by the shareholder in connection with a tax-free corporate reorganization¹⁰ or a tax-free separation of one corporation into two or more corporations.¹¹ Further, the effect of the transaction must be substantially the same as the receipt of a stock dividend or the stock must be received in exchange for section 306 stock.¹² For example, if Corporation *A*, having only common stock outstanding, is merged into Corporation *B* in a statutory merger and, as a result thereof, the shareholders of Corporation *A* receive both common and preferred stock in Corporation *B*, the preferred stock is section 306 stock.¹³

Since stock received will not be hot if it is common stock, it is possible to remove the taint from stock by recapitalizing the corporation and surrendering hot preferred stock in exchange for common stock.¹⁴ This result is permitted because the shareholder has surrendered his possibility of a preferred stock bail-out. Similarly, if preferred stock is issued in exchange for all of the shareholder's common stock, the preferred stock will not be section 306 stock because the effect of the transaction is not the same as a stock dividend.¹⁵

Stock Having a Transferred or Substituted Basis

(3) The term "section 306 stock" also includes any stock (even common stock) the basis of which is determined by reference to section 306 stock held by the shareholder or any other person, other than stock received in a tax-free reorganization or separation.¹⁶ Thus, if a shareholder owns section 306 stock and makes a gift of it to another person, the stock remains section 306 stock in the hands of the donee since the basis of the stock in the hands of the donee is the same as in the hands of the donor.¹⁷ If the definition were otherwise, it would be possible for a

9. *Ibid.* For example, if 100 shares of common stock are distributed in payment of all dividends due on preferred stock, 1/10 of such stock applying to the current year's and the immediately preceding year's dividends and 9/10 to prior arrearages, only 9/10 of each share may be § 306 stock.

10. § 368, which generally involves the tax-free combining of two or more corporations.

11. §§ 355, 356.

12. § 306(c) (1) (B).

13. Reg. § 1.306-3 (d) (Example 1).

14. § 306(e) (1); Reg. § 1.306.3 (d).

15. § 306(c) (1) (B) (ii).

16. § 306(c) (1) (C).

17. § 1015. See SUBCHAPTER C ADVISORY GROUP TO THE WAYS & MEANS COMM., 86TH

shareholder to give hot stock to his spouse, with the spouse subsequently achieving the bail-out.

Similarly, if a shareholder organizes new Corporation *A* and transfers to it his hot preferred stock in Corporation *B* in exchange for all the common stock of Corporation *A*, he could achieve a bail-out at capital gains rates of the earnings of *B* by subsequently selling the stock of Corporation *A*. However, since the transfer of the *B* stock to Corporation *A* in exchange for *A*'s stock is a tax-free incorporation,¹⁸ the *A* stock so received has the same basis as the *B* stock in the shareholder's hands.¹⁹ Accordingly, the stock of *A* will be section 306 stock. Furthermore, the *B* stock now owned by Corporation *A* will remain section 306 stock, since its basis is the same as it was in the hands of the shareholder when he owned it.²⁰

However, section 306 stock will lose its taint when the shareholder dies owning it,²¹ since the basis of the stock in the hands of the executor or heirs will not be determined by reference to its basis in the hands of the decedent but by its fair market value on the date of death or the alternate valuation date.²²

Exception Where Corporation Has No Earnings and Profits

Notwithstanding the fact that a stock distribution may fall within one or more of the foregoing three tests, it will not be section 306 stock if no part of the distribution would have been a dividend at the time of

CONG., 1ST SESS., REV. REPORT ON CORPORATE DISTRIBUTIONS & ADJUSTMENTS 19 (Comm. Print 1958), for a discussion of the situation where the fair market value of the stock is less than the shareholder's basis. In such a situation, the shareholder's basis, under § 1015, for purposes of computing loss is the lesser of the fair market value of the stock on the date of gift or the donor's basis, and accordingly, the stock might lose its taint.

18. § 351.

19. § 358.

20. § 362.

21. Reg. § 1.306-3(e).

22. § 1014. An interesting problem arises when a corporation which is the owner of § 306 stock makes an in kind liquidating distribution of that stock to its shareholders. Thus, assume that Corporation *B* owns § 306 stock of Corporation *A* and that this stock is distributed to the shareholders of Corporation *B* in partial or complete liquidation of Corporation *B*. Although this is a disposition by Corporation *B* of the § 306 stock, § 336 provides that generally no gain or loss is recognized to a corporation on its distribution of property in partial or complete liquidation, and hence § 306 should not be applicable to the disposition. Furthermore, it is difficult to conclude that the receipt by Corporation *B* of its own stock on the liquidation is an "amount realized" by it. Since a partial or complete liquidation of Corporation *B* is taxable to its shareholders, the stock received by them acquires a new basis and does not fall within any of the definitions of § 306 stock. The stock of Corporation *A* has lost its taint and may, therefore, be sold, redeemed, or otherwise disposed of by the shareholders of Corporation *B* without the ordinary income treatment of § 306. See Katcher, *Liquidation Problems and Pitfalls*, N.Y.U. 17TH INST. ON FED. TAX 827, 832 (1959). This result would apparently follow even if Corporation *B* were liquidated in a "one-month" liquidation under § 333 if the § 306 stock of Corporation *A* had been acquired by Corporation *B* after December 31, 1953. See § 333(e) and (f).

distribution if money had been distributed instead of the stock.²³ Since money distributed by a corporation is a dividend only if, and to the extent that, the corporation has earnings and profits,²⁴ a stock distribution will not be section 306 stock unless the corporation has earnings and profits at the time of distribution.²⁵ Section 306 provides that the stock is hot stock unless *no* part of the distribution would have been a dividend if money had been distributed. It follows, therefore, that *all* of a preferred stock dividend will be hot stock even if the corporation had only one dollar of earnings and profits, since in any distribution of money one dollar would have been a dividend.²⁶

Obviously, a newly organized corporation will have no earnings and profits, and, accordingly, any preferred stock issued upon its incorporation will not be section 306 stock.²⁷ It is, therefore, important for the shareholders to determine at the time of incorporation whether a future need or desire for preferred stock is foreseeable. If the need for the preferred stock does not materialize, it can be exchanged for common stock in a tax-free recapitalization,²⁸ and the common stock will not be section 306 stock.²⁹ However, it is not possible to exchange common stock for preferred stock tax free or to issue a preferred stock dividend on the common stock without the preferred stock's being section 306 stock unless the corporation has no earnings and profits at the time of the exchange or dividend distribution.³⁰ Accordingly, the importance of considering the possibility of issuing preferred stock upon incorporation is apparent.³¹

Since preferred stock issued upon incorporation is not section 306 stock,³² if such preferred stock is later sold to a third person for an amount equal to the shareholder's cost,³³ the selling shareholder will not realize taxable gain because the sale is not governed by section 306. Since the stock will not be section 306 stock in the hands of the pur-

23. § 306(c) (2).

24. §§ 301, 316, 317.

25. Reg. § 1.306-3(a).

26. *Ibid.*

27. Stock issued upon incorporation is not § 306 stock for the further reason that its receipt is excluded from the shareholder's income by § 351, not by § 305(a). See Young, *Preferred Stock Bail-Outs: Statutory Restrictions: Pitfalls and Continuing Opportunities Under the 1954 Code (Section 306)*, N.Y.U. 15TH INST. ON FED. TAX 431, 440 (1957).

28. § 368(a) (1) (E).

29. Reg. § 1.306-3(d).

30. § 306(g) (2).

31. This is not to imply that the advantages of "thinning" the corporation by its issuing bonds or other evidences of indebtedness should be ignored.

32. Assuming that § 306 stock was not transferred to the corporation upon its incorporation.

33. A redemption by the corporation, other than a complete redemption of the shareholder's interest in the corporation, would probably fall afoul of the rules for determining when a redemption is taxable as a dividend. See § 302.

chaser, a subsequent redemption of it by the corporation at his cost also may not result in any taxable gain to him. Thus, a bail-out of the corporate earnings will have been effected. The attractiveness of this method is enhanced if the preferred stock is redeemable by the corporation at a price in excess of the consideration paid for it upon issuance; more of the corporate funds may thereby be bailed out and at capital gains rates.³⁴

Such a bail-out appears to be wholly outside the limiting provisions of section 306. The Internal Revenue Service might argue, however, that in effect the purchaser of the stock was merely a conduit through whom the selling shareholder received dividend proceeds from the corporation, especially if it could be shown that the redemption from the purchaser by the corporation had been prearranged.³⁵ The transaction would be treated, according to this argument, as if the preferred stock had been redeemed by the corporation directly from the selling shareholder, and would be taxable as if he had received a dividend unless the redemption were of all of his interest in the corporation or were substantially disproportionate with respect to him.³⁶ If such a redemption is contemplated, it should be delayed as long after the purchase as possible.

TAX CONSEQUENCES OF THE DISPOSITION OF SECTION 306 STOCK

Sales or Dispositions Other Than Redemptions

If a shareholder sells his section 306 stock or disposes of it other than by redemption by the corporation, the entire proceeds received by him are treated as gain from the sale of property which is not a capital asset, *i.e.*, as ordinary income, to the extent that the fair market value of the stock sold, on the date distributed by the corporation to the shareholder, would have been a dividend if the corporation had distributed cash instead of the stock.³⁷ As noted above, the extent to which a cash distribution would have been a dividend depends upon the earnings and profits of the corporation. Since the amount of the non-capital gain is limited to the fair market value of the stock on the date distributed by the corporation to the shareholder, it follows that any appreciation in the value of the stock after the date of distribution will not be taxable as ordinary income under section 306.³⁸

34. Preferred stock which is redeemable at a price in excess of the consideration paid for its issuance is known as "discount preferred stock." It should be noted that legislative recommendations to alter this result have been made. See SUBCHAPTER C ADVISORY GROUP TO THE WAYS & MEANS COMM., 86TH CONG., 1ST SESS., REV. REPORT ON CORPORATE DISTRIBUTIONS & ADJUSTMENTS 10-11 (Comm. Print 1958).

35. Cf. Rev. Rul. 57-328, 1957-2 CUM. BULL. 229.

36. § 302.

37. § 306(a)(1)(A).

38. Reg. § 1.306-1(b)(2).

It is important to note that it is not just the profit on the sale (the excess of the amount realized over the adjusted basis) which is taxable as ordinary income; it is the *entire* amount realized which is so taxable, to the extent stated above. The basis³⁹ of the stock is not subtracted from the amount realized in determining the taxable gain.

If the amount realized upon the sale or disposition exceeds the extent to which the fair market value of the stock sold, on the date distributed by the corporation to the selling shareholder, would have been a dividend if the corporation had distributed cash instead of the stock, such excess is treated as follows:

(1) Such excess is treated as a nontaxable return of capital to the extent of the adjusted basis of the stock.

(2) If such excess itself exceeds the adjusted basis of the stock, the balance is treated as gain from the sale of the stock, which will be capital gain if the stock was a capital asset⁴⁰ in the hands of the shareholder. In other words, any excess of the amount received over the sum of the amount treated as ordinary income plus the adjusted basis of the stock sold may be treated as capital gain.⁴¹

The operation of these provisions may be illustrated as follows: Assume *A* owns all the common stock of a corporation. On December 15, 1960, the corporation distributed to *A* a dividend of fifty preferred shares on his common stock. On that date the preferred stock had a fair market value of \$5,000 and a basis to *A* of \$500. On December 31, 1960, the corporation had earnings and profits of \$20,000. On March 1, 1961, *A* sold the preferred stock for \$6,000. Of this amount, \$5,000 (the fair market value of the preferred stock on the date of distribution) will be ordinary income, \$500 will be a non-taxable return of capital, and \$500 (\$6,000 minus \$5,500) will be capital gain.⁴²

If *A* sold the preferred stock for \$5,100, of this amount \$5,000 will be ordinary income, \$100 will be a non-taxable return of capital, and the remaining \$400 of basis (\$500 minus \$100) will be added back to the basis of the common stock of the corporation on which the preferred stock dividend was declared.⁴³ It may thus be seen that the basis of the section 306 stock is not subtracted from the sale proceeds in determining the amount of the ordinary income.

If *A* sold the preferred stock for \$6,000 but the earnings and profits of the corporation on December 31, 1960, had been only \$4,000, then

39. See §§ 307, 358, for determination of the basis of § 306 stock.

40. See discussion pp. 256-66.

41. Reg. § 1.306-1(b)(1).

42. Reg. § 1.306-1(b)(2).

43. *Ibid.*

\$4,000 will be taxable as ordinary income, \$500 will be a non-taxable return of capital, and \$1,500 will be capital gain.⁴⁴

These examples illustrate the consequences of a sale or other disposition, other than a redemption, of section 306 stock. A question naturally arises as to what is meant by a "disposition" of the stock. The Internal Revenue Service has stated that a pledge of section 306 stock is a disposition under certain circumstances (without elaborating what these circumstances are), particularly where the pledgee can look only to the stock itself as his security.⁴⁵

However, the Service has ruled⁴⁶ that a gift of section 306 stock to a charitable organization is not a disposition giving rise to income either at the time of the gift or the later redemption of the stock from the charitable organization. The Service was careful to point out that there was not a prearrangement for the sale by the charity of such stock or for its redemption by the corporation. It is not difficult to conceive of a different result if the gift to the charity is followed immediately by its redemption, particularly where both the corporation and the charity are controlled by the donor. The result of such a transaction is that the shareholder has used corporate funds to fulfill his charitable wishes without paying any tax thereon, and at the same time he has obtained a charitable deduction for the fair market value of the stock contributed.⁴⁷

It should be noted that since a sale of section 306 stock is treated as the sale of a non-capital asset rather than as a dividend,⁴⁸ the shareholder is not permitted the dividend exclusion,⁴⁹ the dividends-received credit,⁵⁰ or the corporate dividends-received deduction.⁵¹

Finally, in the case of a sale or other disposition, other than a redemption, of section 306 stock, no loss may be recognized.⁵² Presumably, the

44. See Young, note 27 *supra*, at 435-37, with respect to certain basis problems which may arise.

45. Reg. § 1.306-1(b)(1). But see *Woodsam Associates, Inc. v. Commissioner*, 198 F.2d 357 (2d Cir. 1952). *Quaere*: is the amount realized the fair market value of the stock or the amount borrowed?

46. Rev. Rul. 57-328, 1957-2 CUM. BULL. 229.

47. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 100-01 (1959). Legislative recommendations have been made to eliminate this benefit by reducing the amount of the charitable deduction by the amount which would be ordinary income to the shareholder if he had sold the stock. See SUBCHAPTER C ADVISORY GROUP TO THE WAYS & MEANS COMM., 86TH CONG., 1ST SESS., REV. REPORT ON CORPORATE DISTRIBUTIONS & ADJUSTMENTS 17 (Comm. Print 1958). Note that even under this proposed change the gift itself would not be a disposition of the stock.

48. § 306(a)(1).

49. § 116.

50. § 34.

51. § 243.

52. § 306(a)(1)(C).

adjusted basis of the stock will be added back to the basis of the common stock on which the dividend was declared.⁵³

Redemptions

If section 306 stock is redeemed by the issuing corporation, rather than sold to a third person by the shareholder, the entire amount received by the shareholder is treated as if the corporation had made a distribution of property or money to him without the surrender of the stock.⁵⁴ Accordingly, the distribution will be taxable as an ordinary dividend to the extent of the shareholder's ratable share of the corporation's earnings and profits as of the end of the taxable year in which the redemption is made. Any excess of the amount distributed over his ratable share of the earnings will be treated first as a non-taxable return of capital and any balance as capital gain.⁵⁵ For this purpose, the amount of the corporation's earnings and profits at the time the section 306 stock was distributed is immaterial.⁵⁶

If preferred stock was received in a distribution or reorganization prior to June 22, 1954, it is not section 306 stock even if sold or redeemed after that date⁵⁷ unless substantial changes have been made in its terms and conditions.⁵⁸ Stock received after that date is also not section 306 stock if it was received in a transaction subject to the 1939 Code.

Exceptions

The foregoing has set forth the tax consequences of a sale, redemption or other disposition of section 306 stock. There are specified exceptions⁵⁹ to these rules, and it will be seen that the exceptions were generally intended to cover those situations in which a partial bail-out of corporate earnings is not involved.

Thus, if a shareholder sells or otherwise disposes of (other than by a redemption) his *entire* stock interest in the corporation to an unrelated person or persons, then his gain or loss on the transaction will not be subject to the rules of section 306.⁶⁰ Therefore, if the stock is a capital asset and if it is sold at a gain, the gain will be capital gain; if the stock is sold at a loss, the loss will be recognized. The determination of whether the person to whom the stock is sold is unrelated to the selling shareholder

53. See Reg. § 1.306-1(b)(2).

54. § 306(a)(2).

55. §§ 301, 316.

56. Reg. § 1.306-1(c).

57. § 306(h).

58. § 306(g).

59. § 306(b).

60. § 306(b)(1)(A).

involves the complicated rules of the attribution-of-ownership provisions of section 318(a) and is beyond the scope of this paper. Generally, however, unrelated persons are ones who are *not* a spouse,⁶¹ child,⁶² grandchild,⁶³ or parent⁶⁴ of the selling shareholder, a partnership of which the selling shareholder is a partner,⁶⁵ an estate⁶⁶ or trust⁶⁷ of which he is a beneficiary, or a corporation more than fifty per cent of the stock of which is owned by him.⁶⁸ In other words, even if the shareholder disposes of his entire stock interest in the corporation to one of these persons or entities, the treatment of the amount realized with respect to his section 306 stock will be governed by section 306.

It should be noted that this exception deals with the sale or other disposition of the shareholder's entire stock interest; it is not necessary that he dispose of any corporate obligations he may hold as a creditor. It will also not affect the consequences of the transaction if he retains his position as a director, officer, or other employee of the corporation.⁶⁹

The second exception deals with the redemption of a shareholder's section 306 stock. If the redemption is in complete redemption of all of the stock of the corporation owned by the shareholder, then the amount realized by the shareholder will not be treated as the distribution of a dividend to him but will be treated as having been received in exchange for his stock and hence will be eligible for capital gains treatment.⁷⁰ However, if other stock of the corporation is owned by the related persons specified generally above, then the stock of these persons will be deemed still to be owned constructively by the shareholder. All of his stock will, therefore, not have been redeemed, and section 306 will apply to the amount realized by him with respect to his section 306 stock.⁷¹

The third exception also deals with the redemption of a shareholder's section 306 stock. If the shareholder's section 306 stock is redeemed in a distribution in partial⁷² or complete liquidation of the corporation, then the amount realized by the shareholder will not be treated as the dis-

61. § 318(a)(1)(A)(i). See discussion pp. 311-13.

62. § 318(a)(1)(A)(ii).

63. *Ibid.*

64. *Ibid.*

65. § 318(a)(2)(A).

66. *Ibid.*

67. § 318(a)(2)(B).

68. § 318(a)(2)(C).

69. Reg. § 1.306-2(a)(2).

70. § 306(b)(1)(B).

71. § 302(c). Under certain circumstances, all of the shareholder's stock will be deemed to have been redeemed even if members of his family own stock in the corporation. See § 302(c)(2).

72. See § 346 for the definition of a partial liquidation.

tribution of a dividend to him but will be treated as having been received in exchange for his stock and hence will be eligible for capital gains treatment.⁷³

As noted above, if a shareholder organizes a new corporation and transfers his section 306 stock to it in a tax-free incorporation, the stock of the new corporation which he receives will be section 306 stock.⁷⁴ However, the fourth exception provides that the transfer of the section 306 stock to the new corporation will not of itself be a taxable "disposition" of the section 306 stock.⁷⁵ In fact, if the shareholder disposes of his section 306 stock in any manner that is tax-free, then such disposition itself will not be subject to the ordinary income treatment of section 306, but any stock received in exchange for the section 306 stock will probably be section 306 stock and the section 306 stock exchanged will not lose its taint.⁷⁶ Thus, exchanges of section 306 stock solely for stock in connection with a tax-free reorganization,⁷⁷ a tax-free incorporation,⁷⁸ a corporate separation,⁷⁹ or for stock in the same corporation⁸⁰ do not of themselves constitute a disposition taxable under section 306.⁸¹

The final exception to the ordinary income treatment accorded by section 306 is a general escape clause for taxpayers who cannot meet the other exceptions. To avoid taxability under this exception to section 306 upon a disposition of section 306 stock, the shareholder must establish to the satisfaction of the Internal Revenue Service that both the distribution⁸² of the section 306 stock to him by the corporation and the disposition or redemption of the stock were not in pursuance of a plan having as one of its principal purposes the avoidance of federal income tax.⁸³ If the section 306 stock is disposed of or redeemed and prior thereto or simultaneously therewith the common stock with respect to which the section 306 stock was distributed is disposed of or redeemed, the shareholder need not prove anything with respect to the *distribution* of the section 306 stock, but he must still prove the *disposition* or *redemption* of the section 306 stock was not in pursuance of such a plan.⁸⁴ It is not enough to show that there were valid non-tax reasons for disposing

73. § 306(b) (2).

74. § 306(c) (1) (C).

75. § 306(b) (3).

76. §§ 306(c) (1) (B) and (C).

77. See § 368.

78. See § 351.

79. See § 355.

80. See § 1036.

81. Reg. § 1.306-2(b) (2).

82. Rev. Rul. 56-116, 1956-1 CUM. BULL. 164.

83. § 306(b) (4) (A).

84. § 306(b) (4) (B); Reg. § 1.306-2(b) (3).

of the stock. If tax avoidance was merely one of several principal reasons, the exception will not be applicable and the ordinary income treatment of section 306 will result.

Generally, isolated dispositions of section 306 stock by minority shareholders will fall within this exception,⁸⁵ especially where publicly held corporations are involved.⁸⁶ Similarly, if a shareholder sells all of his voting common stock before he disposes of his section 306 stock, the subsequent disposition of his section 306 stock will not ordinarily be considered a disposition, one of the principal purposes of which is the avoidance of federal income tax.⁸⁷ This presumably would include a sale to a related person, for if the purchaser were unrelated, the sale would be excepted from section 306 treatment as a disposition of the shareholder's entire stock interest in the corporation and there would be no need to rely on the general escape clause.

CONCLUSION

Section 306 appears generally to have fulfilled the congressional purpose of closing the preferred stock bail-out loophole. However, it should not be inferred that it has eliminated all business and tax uses for preferred stock. Preferred stock is still useful as "leverage" stock⁸⁸ and in such areas as intracorporate relationships⁸⁹ and estate planning. Nevertheless, a thorough understanding of section 306's restrictive effect upon capital gains treatment is essential to advising with respect to any transaction involving stock which may be within its provisions.

85. Reg. § 1.306-2(b)(3).

86. Rev. Rul. 57-212, 1957-1 CUM. BULL. 114; Rev. Rul. 57-103, 1957-1 CUM. BULL. 113.

87. Reg. § 1.306-2(b)(3). See also Rev. Rul. 56-223, 1956-1 CUM. BULL. 162.

88. See Calkins, Coughlin, Hacker, Kidder, Sugarman & Wolf, *Tax Problems of Close Corporations: A Survey*, 10 WEST. RES. L. REV. 9, 98 (1959).

89. *Id.* at 99.