Articles

Hester Prynne, Lydia Bennet & Section 306 Stock

The Concept of Tainting in the American Novel, the British Novel & the Internal Revenue Code

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I NEED TO SOLVE a literary-legal mystery: Did Nathaniel Hawthorne's novel, *The Scarlet Letter*, inspire Section 306 of the Internal Revenue Code? The need is urgent. With each passing day, Section 306 becomes increasingly irrelevant. If an answer does not appear soon, literary theorists and tax lawyers may lose interest, and an insight into American culture may be lost.

Section 306 adopts a peculiarly Hawthorne-like solution to a tax avoidance scheme known as the "preferred stock bailout." In 1953 the Sixth Circuit, surprisingly, blessed the preferred stock bailout in the case of *Chamberlin v. Commissioner*.[1] One year later, Congress enacted Section 306 to reverse the Sixth Circuit's decision. The facts of the preferred stock bailout scheme in *Chamberlin* are as follows.

C.P. Chamberlin and his wife, Grace, owned nearly 85% of the common stock of the Metal Moulding Corp. (MMC), located in Detroit, Michigan. MMC, which began operations in 1924, sold bright metallic trim to the producers of American automobiles. With the end of World War II, American auto manufacturers shifted their production from war materials to consumer goods. There was tremendous pent-up consumer demand for cars and virtually no competition from foreign manufacturers. Automobiles of that period, as older readers may recall, were garishly adorned with metallic trim of the type produced by MMC.

Thus, after World War II, MMC earned enormous profits. In 1946 alone, the company's accumulated profits increased by 47% over the total for the previous 21 years of its history.[2]

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1 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 346 U.S. 918 (1954).

2 By the end of 1945, the total of accumulated after-tax profits was $1,425,000. During 1946, accumulated after-tax profits rose by an additional $665,000.

These large profits created a tax problem for Mr. and Mrs. Chamberlin, MMC's largest stockholders. The Chamberlins wanted MMC to distribute its after-tax corporate profits. However, the Tax Code decreed, then as now, that distributed corporate earnings are dividends and that a shareholder who receives dividends pays tax on the entire amount at ordinary income rates. For the 16 years after World War II, the top ordinary income tax rate (to which the Chamberlins were probably subject, given MMC's prosperity) was an all-but-confiscatory 90%.[3]

Therefore, the Chamberlins devised the following three-step transaction. In the first prearranged step, they caused the corporation to distribute to its common stockholders a dividend consisting not of cash but of newly issued shares of the corporation's own nonvoting preferred stock. In the second prearranged step, the shareholders sold their preferred stock to two insurance companies for about $800,000. Finally, in the third prearranged step of the plan, stretching over seven years, the corporation itself redeemed the entire issue of preferred stock, buying it back from the insurance companies for $800,000.

What tax treatment did the Chamberlins claim? On the first step, the distribution of the preferred stock dividend, they claimed nonrecognition. For this position they had solid authority: The Supreme Court had repeatedly held that such stock dividends, unlike distributions of cash, are mere paper transactions and therefore merit nonrecognition.[4] Moreover, Congress had acceded to the Court's judgment and amended the Internal Revenue Code to provide tax-free treatment for stock dividends distributed pro rata on common stock.[5]

As for the second step of the transaction, the sale of their new preferred stock to the insurance companies for $800,000, the Chamberlins argued that they should be taxed like any other seller of property. Therefore their income was not the entire $800,000 but only the amount by which the sales price exceeded their basis in the stock.[6] Moreover, this income was taxable only at the capital gains rate, at the time 25%, much lower than the top 90% rate for ordinary income.[7]

Finally the Chamberlins stated that the third step of the transaction, the corporation's redemption of its stock from the insurance companies, did not involve them at all and therefore should have no effect on their tax treatment.

Nevertheless, the net effect of all three steps taken together was economically indistinguishable from a distribution by MMC to its shareholders of an $800,000 cash dividend, which would have been taxed to them in full as ordinary income. After completion of the entire three-step transaction, the Chamberlins still owned nearly 85% of MMC's equity, which, as before the transaction started, consisted entirely of common stock. The only changes at the end of the three-step transaction were that MMC had $800,000 less cash, and the Chamberlins and other common stockholders had $800,000 more cash. The insurance companies, for their part, appeared to serve as a mere conduit for disguising a cash dividend distribution from MMC as a sale to an outside party. The Chamberlins had used preferred

3 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates, and Gifts*, pp. 1-13 (3rd ed. 1999).

4 *Towne v. Eisner*, 425 U.S. 418 (1918); *Eisner v. Macomber*, 252 U.S. 189 (1920); *Helvering v. Griffiths*, 318 U.S. 371 (1943); *Helvering v. Sprouse*, 318 U.S. 604 (1943); *Strassburger v. Comm'r*, 318 U.S. 604 (1943).

5 Under current law, I.R.C. § 305(a) provides for tax-free treatment of stock dividends – subject, however, to numerous exceptions.

6 Under current law, I.R.C. § 307(a) provides that the basis of the original common stock is allocated between the original common stock and the preferred stock that is received as a tax-free dividend.

7 Bittker & Lokken, *supra*, n. 3.

stock to distribute, or "bail out," corporate profits at capital gains rather than ordinary income rates. Hence tax lawyers described the scheme as a "preferred stock bailout."

The Chamberlins' case went to the Tax Court, which showed no reluctance in holding that the Chamberlins had effectively received a cash dividend and should be taxed accordingly.[8] Yet on appeal the Sixth Circuit reversed. What might explain the Court of Appeals' extraordinary decision?

One factor was that the Chamberlins, who had competent but undistinguished Detroit counsel in the Tax Court, retained new attorneys for the appeal to the Sixth Circuit. In an inspired move, the Chamberlins hired Randolph Paul and Louis Eisenstein of Washington, D.C., considered the two most accomplished tax attorneys in the nation. It must have been especially difficult for the Internal Revenue Service to litigate against Randolph Paul, co-author of the standard treatise on federal income taxation,[9] which judges routinely consulted in difficult tax cases.[10]

In addition, the IRS weakened its case by making a much broader argument than it needed to win. The Service might have argued simply that the effect of all three steps of the *Chamberlin* transaction was equivalent to a cash dividend. On two previous occasions, the Supreme Court had already decided that if formally separate steps, like the three steps in *Chamberlin*, have the effect of a dividend, they should be taxed as a dividend.[11]

However, the IRS added that it was the distribution of the preferred stock in step one of the transaction that should be treated as producing a taxable dividend. By refusing to concede that the distribution of the preferred stock dividend should be tax-free, the Service was attacking a long-established principle, explicitly approved by both the Supreme Court and Congress.

The Service's "step one" argument thereby provided Randloph Paul and Louis Eisenstein with a delectable target. Asking the Sixth Circuit to reverse, they wrote,

> The issue in this case is easily stated. May the [IRS] zealously disregard the network of rules so carefully devised by Congress, the courts, and itself because it would now write them differently if it were free to do so? The [IRS] tacitly assumes that [it] enjoys this sweeping power to determine fiscal policy. … We respectfully submit that the [IRS] has wandered well beyond the relevant statutes and disingenuously improvised a tax policy of its own … .
>
> The Tax Court, in the fashion of the [IRS], has called upon some brooding "spirit" that is neither expressed nor restrained by any words that Congress has ever used. Since the opinion is untrammeled by any statute, it is vagrant and unconfined. Inevitably, it leads into a quagmire of confusion where any intelligible principles of law sink and disappear. Whatever rule the Tax Court's opinion may attempt to state is no rule at all. The opinion is a standing invitation to chaos in the taxation of stock dividends – a chaos [that] a proper deference to Congress would refuse to attribute to that body.[12]

The Sixth Circuit, however, went too far in

8 18 T.C. 164 (1952).

9 Randolph E. Paul & Jacob Mertens, Jr., *The Law of Federal Income Taxation* (1935).

10 Judge Jerome Frank, the distinguished Second Circuit jurist, referred to Randolph Paul as "our most eminent tax commentator." Harry J. Rudick, *Randolph E. Paul*, 11 Tax L. Rev. 201 (1956).

11 *Gregory v. Helvering*, 293 U.S. 465 (1935); *Bazley v. Comm'r*, 331 U.S. 737, *rehearing denied and prior op. amended*, 332 U.S. 752 (1947). Both opinions emphasized that the taxpayer's predominant motive was tax avoidance, as was also the case in *Chamberlin*.

12 Brief for Petitioners, *Chamberlin v. Comm'r, supra, quoted in* M. Carr Ferguson, *The Legacy of Louis Eisenstein*, 22 Tax L. Rev. 7, 9-10 (1966).

ignoring the connections among the steps in the *Chamberlin* transaction. In refusing to treat the entire transaction as a dividend, the Sixth Circuit emphasized that seven years elapsed between the sale of the preferred stock to the insurance companies and the complete redemption of the preferred from the insurance companies by MMC.

> [I]n the absence of a finding that it was immediately or shortly thereafter redeemed … , we assume that a large portion of [the preferred stock] has remained outstanding over a period of years with some of it still unredeemed after nearly seven years.[13]

However, contrary to the court's assumption, the fact that the preferred stock was outstanding for up to seven years seems irrelevant. The corporation had committed itself to redeem the preferred at a definite price and according to a fixed schedule. The preferred stock benefited from numerous protective provisions, including the requirement of a sinking fund to guarantee that MMC would have enough cash to fulfill its redemption commitment. Thus, at the moment when the Chamberlins made their sale to the insurance companies in step two, it was nearly certain that MMC would redeem the preferred stock in step three. Indeed, had there actually been a substantial risk of nonredemption, state prudent investor laws would probably have prohibited the insurance companies from purchasing the MMC preferred stock in the first place.

The Sixth Circuit's decision in favor of the taxpayers in *Chamberlin* raised an ominous possibility. The court had provided a roadmap for shareholders of close corporations who wished to cash out corporate profits while avoiding taxation at ordinary income rates. Instead of taking out such profits through cash dividend distributions, shareholders would simply employ preferred stock bailouts. Closely held corporations might stop paying regular cash dividends altogether.

Congress responded to this danger with Section 306, which artfully avoids the weaknesses of the IRS's position in *Chamberlin*. Section 306 does not tax the distribution of preferred stock as a dividend, the result advocated without success by the IRS in *Chamberlin*. Instead, Section 306 accepts the principle that a distribution of preferred stock on common shares should be tax-free. What Section 306 does instead of challenging this principle is to taint the preferred stock.

Section 306 labels the preferred stock as "Section 306 stock."[14] Special rules then govern the subsequent disposition of this tainted stock. If it is sold, the usual rules governing stock sales, including recovery of basis and capital gains treatment, do not apply. Instead, the sale proceeds are in effect taxed as if a cash dividend had been paid.[15] Thus, Section 306 attacks the *Chamberlin* transaction at "step two," treating the sale proceeds as if they had been cash dividends received from the corporation.

There are exceptions to the special disposition rules if the sale of Section 306 stock does not constitute a bailout. For example, if a taxpayer sells his entire equity interest in a corporation, including both 306 and non-306 stock, then the special disposition rules do not apply.[16] Nor should they, because the shareholder could have sold his entire stock interest before the distribution of Section 306 stock and received sales treatment,

13 *Chamberlin*, 207 F.2d at 471.
14 I.R.C. § 306(c).
15 I.R.C. § 306(a)(1)(A).
16 I.R.C. § 306(b)(1)(A).

including recovery of basis and the benefit of lower capital gains rates.

Section 306, with its concept of a taint that can dog a stock from acquisition to disposition, seems designed by a novelist rather than a tax technician. So I called a friend who teaches English at a major university and asked specifically: Did Nathaniel Hawthorne's *The Scarlet Letter* inspire Section 306? Here is a more-or-less verbatim transcript of our conversation.

I said, "Section 306 of the Internal Revenue Code was enacted to prevent tax avoidance. If taxpayers acquire stock suitable for tax avoidance, Section 306 taints the stock and applies special rules to the stock's disposition. This tainting of stock is like the tainting of Nathaniel Hawthorne's heroine, Hester Prynne, who had to wear a scarlet A. The comparison seems too close to be just coincidence. What do you think?"

She said, "My field is the nineteenth century British novel. I barely remember *The Scarlet Letter*. I haven't read it since junior high school."

I pressed on: "All right; in the nineteenth-century British novel, is there a similar concept of tainting?"

She said, "It doesn't apply. In the nineteenth-century British novel, you are either in or you are out."

I said, "What do you mean?"

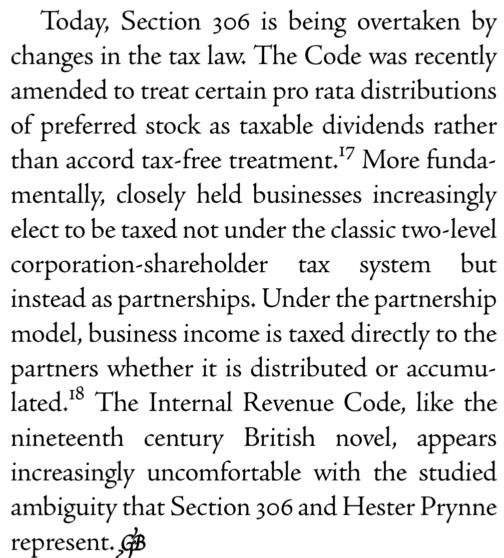
She said, "For example, take Jane Austen's *Pride and Prejudice*. Lydia Bennet runs off with Mr. Wickham. They have an affair. But her family rushes in and quickly arranges a marriage. That is the only way she can remain in the novel. If the family had not been able to arrange the marriage, Lydia would have been dropped from the novel altogether. You see? In the nineteenth century British novel, there is no concept of tainting. Either you're in or you're out."

"So," I said, "in the nineteenth-century British novel, tainting is not an acceptable option."

She said, "Right. Either your existence is fully acknowledged or it is not acknowledged at all. Not like Hester Prynne in *The Scarlet Letter*, who was tainted or half-acknowledged."

What my friend said about Jane Austen applies to the Internal Revenue Code as well. Usually an asset is either a capital asset, whose disposition produces a favored capital gain, or it's not. But 306 stock, like Hester Prynne, has an ambiguous status. If the stockholder attempts to use the stock to achieve a bailout, ordinary dividend taxation results. But if the owner, in an act of renunciation, sells his entire equity interest, the preferred stock is cleansed of its Section 306 taint.

Today, Section 306 is being overtaken by changes in the tax law. The Code was recently amended to treat certain pro rata distributions of preferred stock as taxable dividends rather than accord tax-free treatment.[17] More fundamentally, closely held businesses increasingly elect to be taxed not under the classic two-level corporation-shareholder tax system but instead as partnerships. Under the partnership model, business income is taxed directly to the partners whether it is distributed or accumulated.[18] The Internal Revenue Code, like the nineteenth century British novel, appears increasingly uncomfortable with the studied ambiguity that Section 306 and Hester Prynne represent.



17 I.R.C. §§ 351(g), 354(a)(2)(C), 356(e).

18 I.R.C. § 701.