Roberts & Holland LLP

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When Should a Distribution Be Taxed As an Exchange? *Steel v. Commissioner*

By: Elliot Pisem and David E. Kahen

A disposition of all the stock of a corporation is frequently accompanied by a distribution of property by the corporation to the selling shareholder(s). Will receipt of such a distribution be treated as additional consideration received in exchange for stock and, therefore, as potentially giving rise to capital gain to the shareholders? Or, will the distribution not be treated as an exchange at the shareholder level, but rather as a dividend, taxable as ordinary income, to the extent of the corporation's earnings and profits?

Under the seminal case of *Zenz v. Quinlivan* and subsequent authority, it is generally accepted that capital gain treatment will be available where shareholders sell a portion of their stock in a corporation and the balance of their stock is redeemed by the corporation, before or after the sale, pursuant to an integrated plan.

The redemption proceeds will generally be treated as received in an exchange because the shareholders' interests in the corporation have been terminated as a result of the overall transaction. This is so even if a distribution in redemption of a portion of the selling shareholders' stock would, standing alone, have been characterized as a dividend (e.g., because the redemption was pro rata to the pre-sale shareholders).

In a recent memorandum decision of the Tax Court, however, the court found that a distribution authorized by a stock purchase agreement ultimately gave rise to ordinary income, rather than to additional proceeds from the sale of stock, notwithstanding that the distribution was made after the agreement was entered into and on the date the stock was sold.

Facts

In *Steel v. Commissioner* (TC Memo 2002-113), the petitioners Mark Steel and Odd-Bjorn Huse were members of Bochica Partners, a partnership formed to acquire all of the stock of Birting Fisheries, Inc. ("BFI"). BFI was engaged in a commercial fishing business.

BFI suffered losses attributable to mechanical breakdowns of a fishing boat and filed a claim with its insurer. The insurer paid approximately $1 million with respect to the insurance claim but disagreed with BFI as to the overall amount of the loss, and BFI therefore filed a lawsuit against the insurer in September, 1995.

In January, 1996, Bochica agreed to sell all of the common stock of BFI for $9 million, subject to adjustments for various items including tax-related amounts. The stock purchase agreement provided that BFI could assign its rights under the lawsuit against the insurer to the partners of Bochica before the closing date.

On February 15, 1996, the directors of BFI consented to the assignment of the lawsuit to a corporation owned by the partners of Bochica. On February 16, an assignment agreement was executed to assign the lawsuit to that corporation for the benefit of the individual partners of Bochica.

There was no consideration for the assignment other than an undertaking to indemnify BFI and hold it harmless from any liabilities relating to the lawsuit. Bochica sold the BFI stock on the same day as the assignment of the lawsuit.

Although the lawsuit assignment was in substance a distribution, Bochica did not report any tax consequence from the assignment, apparently on the theory that the value of the lawsuit was speculative and could not be ascertained.

The insurer made additional payments aggregating approximately $1.7 million in 1996 and 1997 with respect to the claim, with the final payments being made in settlement of the lawsuit. After taking into account expenses relating to the lawsuit, the petitioners reported the payments received as additional proceeds from the disposition of BFI's stock in Bochica, resulting in long term capital gain.

The IRS computed tax deficiencies with respect to the petitioners for 1996 and 1997 on the premise that the payments received from the insurer were not proceeds from the sale of stock, and constituted ordinary income.

Discussion of Issues

The Tax Court first noted that the gains at issue could constitute capital gains only if they were from the "sale or exchange" of capital assets.

The opinion noted that the receipt of payment in compromise or collection of a debt or to terminate other property rights does not constitute a "sale or exchange" of property in the absence of a statutory provision mandating exchange treatment in a particular case. The Tax Court's decision in *Nahey v. Commissioner* was then cited for the proposition that payments received in settlement of a lawsuit arising from a claim that had been purchased as part of the purchase of the assets of a business did not arise from a "sale or exchange" of that claim and therefore gave rise to ordinary income.

The petitioners attempted to distinguish *Nahey*, as involving a situation where a claim was bought by the purchasers of a business, rather than being transferred to sellers who were disposing of their equity interests, but the court found this distinction unpersuasive and concluded that the proceeds from the insurance lawsuit were not received in a "sale or exchange" of the claim against the insurer.

The petitioners also made what appears to have been a stronger argument that the requisite "sale or exchange" could be found by treating the proceeds of the insurance lawsuit as partial consideration for their stock. They argued that, under the principles of the open transaction doctrine, no amount was required to be reported as income with respect to the lawsuit at the time of its assignment, because the value of the claim was disputed and could not be ascertained, and that open transaction treatment which the IRS apparently did not challenge required the characterization of the gain resulting from amounts received thereafter as capital gain arising from disposition of Bochica's stock in BFI.

The court did not take issue with the petitioners' premise that the lawsuit proceeds, when ultimately received, would constitute capital gain if the lawsuit had been assigned in exchange for stock, but concluded instead that there was no such exchange.

The court first noted that, as a general rule, a taxpayer is bound by the form selected. In this case, the form of the transaction was a distribution of the claim followed by a sale of all of Bochica's stock, with no stock being transferred by Bochica to the corporation in direct exchange for the claim.

The court also noted that the stock purchaser was not involved in the assignment, and that there was no indication that the parties viewed the claim, in an alternative road to capital gain treatment, as having been distributed to the purchaser and as then having been assigned by the purchaser to Bochica or its owners as additional consideration for the stock.

The petitioners stressed that the assignment of the lawsuit was provided for in the contract of sale. The court conceded that the distribution and the stock sale "may have been interrelated," but was unconvinced that the distribution should be integrated with the stock transaction.

The opinion noted that, although the stock purchase agreement permitted the assignment of the insurance claim as a condition to closing, it did not require such an assignment. Of course, assuming that the claim constituted a potentially valuable asset and that there were no associated liabilities potentially exceeding its value, and given that there was no reduction to the purchase price associated with the assignment, the parties could be confident that the claim would in fact be withdrawn from BFI, so it is not clear why the absence of an obligation to assign the claim should affect the legal analysis.

The Tax Court had previously applied step transaction principles to integrate a redemption of stock with a stock sale. The *Steel* court, however, found it highly significant that the Tax Court's earlier case had involved a situation where the taxpayer's interest in the corporation was terminated simultaneously with the distribution. By contrast, the BFI stock purchase agreement contemplated that the distribution could occur before the closing date and the distribution in fact occurred before the sale, albeit on the same day. The relevance of this distinction is not made clear.

Observations

Much of the Tax Court's opinion in this case seems strangely off the mark. For example, the opinion's repeated references to the absence of any evidence that the parties viewed the assignment of the lawsuit as a distribution to the buyer seem, at least to the authors, to be something of a red herring.

Even if the assignment of the lawsuit was to be treated as a distribution to the sellers, the crucial legal question was whether, in determining the tax effect to the sellers of such a distribution immediately before the sale, it was permissible to take into account the sale and resulting complete termination of the shareholders' interests.

If there had been a sale of most of Bochica's shares followed by a redemption of the remaining shares in exchange for the lawsuit, the distribution would have been squarely within *Zenz v. Quinlivan*, which concluded that such a distribution is not essentially equivalent to a dividend and constitutes an exchange for tax purposes. Moreover, rulings published by the IRS after *Zenz* (e.g., Rev. Rul. 75-447) have made reasonably clear that a stock redemption in connection with a sale will be treated as an exchange regardless of whether the redemption of shares occurred before or after the sale of stock to the buyer, so long as both events are clearly part of an overall plan.

Based on *Zenz* principles, one would expect the distribution of the claim to have resulted in capital gain to the shareholders if the overall transaction had included an actual redemption of some of the sellers' shares in exchange for the claim. *Steel*, however, does not discuss *Zenz* at all.

A more difficult question, perhaps, is whether the *Zenz* result should have applied in the circumstances before the court, where there was no redemption in form, given that a presumably pro rata redemption of shares would have been meaningless as an economic matter.

Here, the issue of whether a taxpayer may challenge the treatment of a transaction in accordance with its form has some relevance. However, in at least one analogous context, involving the application of the "partial liquidation" provisions of Code section 302, the IRS has conceded that a pro rata distribution not involving an actual redemption of any shares should be given the same effect as a pro rata redemption. (See Rev.Rul. 90-13, 1990-1 C.B. 65. Additional cases and rulings bearing on this issue are discussed in *Estate of Durkin v. Commissioner*, 99 T.C. 561 (1992)).

If the parties had structured the assignment of the claim as a redemption, with Bochica surrendering (perhaps) a small number of shares in exchange for the assignment, they would have effectively conceded that the value of the claim was not less than that of the quantity of shares surrendered in exchange for the claim. BFI might then have been required to recognize gain under Code section 311 to the extent of such value (assuming a zero basis for the claim), and to make a provision for any tax due as a result of recognition of that gain.

This approach might in turn have both reduced the purchase price for the stock and required the petitioners to recognize additional gain at the time of the sale. Had this approach been adopted, however, it seems likely that the petitioners would have fared better with respect to the income characterization issue.