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The Schnepper Trust: Eliminating the Section 306 Taint

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In order to prevent the distribution of corporate income in the form of preferred stock which, upon sale by the distributee, would otherwise qualify for capital gains treatment, section 306 of the Internal Revenue Code provides that all such stock is tainted at the time of distribution, and that any gain upon sale is taxed as ordinary income. The author suggests a method by which such taint can be removed, and income received upon sale taxed at capital gain rates. This method entails putting the 306 stock in a trust along with potentially appreciable property. When the trust sells the subsequently appreciated property and realizes a capital gain, it makes a distribution in kind of the 306 stock. As such, the stock's basis in the hands of the beneficiary is determined by reference to its fair market value, and the taint is thus purged.

The role of a tax advisor is to plan for potential tax problems before they arise. His optimal objective is the complete avoidance of taxation, or, if this is not obtainable, the minimization of his client's future taxes.[1] One way the advisor seeks to do this is by converting fully taxable ordinary income into tax advantaged capital gains.[2] Assuming a taxpayer-client is in an upper income bracket and runs his own business in corporate form, such conversion of ordinary income into capital gains may be attempted through certain dividend distributions. For simplicity it is assumed further that the client is the sole shareholder.

If a shareholder receives a cash dividend on his common stock it is fully taxable as ordinary income to the extent of corporate

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1. Judge Learned Hand stated: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2d Cir. 1934).

2. Individual ordinary income tax rates range from 14 percent to 70 percent. Int. Rev. Code of 1954, § 1. Generally, only one-half of net long term capital gains are includable in gross income, thus the maximum tax rate on such income is 35 percent. Int. Rev. Code of 1954, § 1202. The first $50,000 of long term capital gains received in a tax year is taxable at a maximum rate of 25 percent. Int. Rev. Code of 1954, § 1201(b).

earnings and profits.[3] If he receives a stock dividend in the form of additional common shares, he is not taxed upon distribution.[4] However, as he owned the whole pie before and after distribution, all he has accomplished is to cut it into smaller pieces. If he then sells the new stock dividend shares, he has in effect done nothing more than sell part of his original ownership equity with a corresponding loss of control and potential future gains. While the taxable effect of the sale would be capital gains, the intermediate step of declaring the stock dividends would have been futile.

What the corporate shareholder is attempting to do is to take cash out of his company and have it taxed at capital gain rates, while not giving up any of his ownership of the corporation. Therefore, he might distribute to himself a dividend of preferred rather than common stock. Such a distribution would be protected from taxation at that point,[5] and the new preferred shares would get an allocable pro rata basis from the original common stock.[6] Since the shareholder wants cash, not new stock, he could sell the preferred stock to a bank, insurance company, or other investor under a plan to have the stock redeemed by the corporation. A sale of preferred stock normally would be taxed at capital gain rates. This is the classic preferred stock bail-out, where an attempt is made by a shareholder to take cash out of his corporation at capital gain rates, and yet retain full control by using preferred rather than common stock.

Prior to the 1954 Code, such preferred stock bail-outs were a court approved device by which earnings and profits could be extracted from a corporation, and taxes paid at capital gain rather than ordinary rates.[7] In 1954 Congress moved to plug this loophole by the enactment of section 306.[8]

Section 306(c)(1)(A) provides that preferred stock received as

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3. INT. REV. CODE OF 1954, § 301.

4. *Id.* § 305(a).

5. *Id.*

6. *Id.* § 307(a).

7. In Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954), decided under the 1939 code, the court specifically validated this type of bail-out even though the corporation initially had no preferred stock outstanding, and there was a prearranged plan for its sale and retirement over a period of 7 years.

8. Section 306 provides that a stock dividend, other than common stock issued with respect to common stock, which meets one of the definitions of § 306(c) is classified as "§ 306 stock" and is taxed as ordinary income upon sale or other disposition (other than a redemption) in accordance with § 306(a). Two of those definitions (§ 306(c)(1)(A) and §

a dividend on common is to be classified as "section 306 stock" because the distribution was not includable in the shareholder's gross income by reason of section 305(a).[9] When this preferred stock is distributed, it becomes tainted. If and when it is sold, the full amount realized by the shareholder may be taxable as ordinary gain from the sale of a non-capital asset to the extent of earnings and profits in the corporation, measured as of the year the stock was distributed and limited by the fair market value of the preferred stock at the time of distribution. Any excess over such earnings and profits and the stock's adjusted basis may be taxed at capital gain rates.[10]

Therefore the shareholder's attempted preferred stock bail-out of cash at capital gain rates would fail. Worse still, had he taken a straight cash dividend, that dividend would have reduced the corporation's earnings and profits[11] and would have given the shareholder an additional $100 exclusion for dividends received.[12] As the sale of the section 306 stock is treated as a sale of a noncapital asset, it neither reduces the corporation's earnings and profits, nor qualifies for the dividends received exclusion.

The shareholder therefore may try a new tactic by giving the preferred stock to his son to sell to an investor. Unfortunately, this too will fail. Since the stock was received as a gift, the son's basis under section 1015 is that of his father (donor's basis).[13] Under section 306(c)(1)(C), Congress has dictated that the section 306 taint remains whenever the preferred stock is transferred to someone whose basis is determined by reference to the original shareholder's basis.[14]

306(c)(1)(C)) are discussed *infra*. Section 306(c)(1)(B) (dealing with tax free reorganizations) is not relevant to this discussion.

Note that § 306(c)(2) provides an additional exception not relevant here where a corporation has no earnings and profits at the time of distribution.

9. Section 305(a) provides that, with certain exceptions not applicable here, "gross income does not include the amount of any distribution of the stock of a corporation made by such corporation to its shareholders with respect to its stock."

10. INT. REV. CODE OF 1954, § 306(a)(1). Note that a redemption of § 306 stock is treated differently. In that case, the entire amount paid for it is treated as a dividend under § 301.

11. INT. REV. CODE OF 1954, § 312(a).

12. *Id.* § 116(a).

13. *Id.* § 1015(a).

14. Note that § 306(c)(1)(A) only applies where the sale, disposition, or redemption was effected by the person to whom the § 306 stock was originally distributed whereas § 306(c)(1)(C) applies to *any person* holding stock with a substituted basis.

The corresponding Regulations go on to specifically eliminate from the section 306(c)(1)(C) definition of 306 stock, that stock the basis of which "is determined by reference to its fair market value on the date of the decedent-stockholder's death . . . under section 1014."[15] This does the shareholder little good where he desires to purge the taint prior to his death.

Beyond this exception, however, neither the Code nor the Regulations specifically refer to other situations where the basis of previously tainted 306 stock is no longer determined by reference to the basis of 306 stock. Presumably, such other situations do not give rise to 306 stock since they are not so defined in section 306 (c)(1)(C) (nor, for that matter, in section 306(c)(1)(A) nor (B)).[16]

The subject of this paper is a suggestion of such a situation, and its possible use in tax planning, by which section 306 stock may be purged of its taint, thus allowing disposition and taxation at capital gain rates and other benefits.

The tax advisor might suggest the use of a Schnepper Trust[17] to solve his client's problem. Assume that section 306 preferred stock with an adjusted basis of $25, along with other potentially appreciable property,[18] is transferred to a short term trust which is irrevocable for more than 10 years so as to qualify under section 673(a).[19] The grantor's son would be the income beneficiary with the father having a reversionary interest.

Assume that after a period of time, the potentially appreciable property does appreciate from $50 to $150. The trust then sells this non-306 property[20] which results in a capital gain of $100. Assuming the trust agreement so provides, and gives the trustee the power to

15. Treas. Reg. § 1.306-3(e) (1960).

16. For example, where a donee sells § 306 stock at a loss, and the basis was greater than the fair market value at the date of the gift, his basis is the fair market value at the date of the gift and, therefore, not determined "by reference to the basis . . . of § 306 stock" as defined in § 306(c)(1)(C). INT. REV. CODE OF 1954, § 1015(a).

17. Named after Simon Schnepper PBR (Ret.) of West Palm Beach, Florida.

18. These are certain types of property which are almost certain to appreciate and produce long term capital gains on their sale. Quality corporate or Treasury deep discount (not original discount) bonds are an example. The realization of the discount on either sale or maturity will produce capital gains. INT. REV. CODE OF 1954, § 1232(a).

19. The transfer of income producing property to a trust may result in gift taxes under § 2511. The desired removal of § 306 taint can also be achieved by use of an irrevocable trust.

20. One must be careful, though, to avoid a sale potentially characterized as a prearranged disposition, or the gain could be attributed to our original shareholder (father) with a possible retention of the § 306 taint.

make such distributions, the trustee may then make a distribution in kind of the preferred stock, which has a fair market value of $100,[21] to the income beneficiary. The trust gets a distribution deduction of $100[22] and therefore pays no taxes. The capital gain on the sale is passed through and reported by the income beneficiary.[23]

Even more importantly, the basis of the preferred stock in the hands of the beneficiary is determined by reference to its fair market value,[24] rather than a substituted basis determined by reference to the donor. Therefore, $75 of capital gain is completely avoided[25] and the preferred stock has lost its section 306 taint! In effect, by laundering the preferred stock through the distributable net income of the trust, the beneficiary has taken cash out of his father's corporation without paying a tax on the built-in appreciation. Furthermore, when the cash left in the trust is either distributed to the beneficiary or remainderman, no tax consequences will result as there is no trust income.

In order for this tax magic to occur, there are several conditions which must be satisfied. First, the trust must not be considered a simple trust. In Revenue Ruling 67-74,[26] it was held that where a simple trust distributed appreciated property with a fair market value equal to the income of the trust, such distribution resulted in a recognition of income to the trust to the extent the fair market value exceeded the trust's basis. Presumably, if such a distribution is made with section 306 stock, the trust will recognize ordinary income under section 306(a)(1). Making the trust a complex trust, therefore, would presumably avoid the applicability of this revenue ruling.[27]

Second, the fair market value of the preferred stock distributed should be equal to or less than the distributable net income of the trust for the top year of the distribution. To the extent the distribution in kind is not included in the income of the beneficiary, he

21. Generally, the fair market value of a preferred stock received as a dividend on common stock will exceed the basis allocated under § 307(a).

22. INT. REV. CODE OF 1954, § 661(a); Treas. Reg. § 1.661(a)-2(f)(2).

23. INT. REV. CODE OF 1954, § 662(b).

24. Treas. Reg. § 1.661(a)-2(f)(3) (1956).

25. For a thorough explanation of this tax phenomenon, see M. FERGUSON, J. FREELAND & R. STEVENS, FEDERAL INCOME TAXATION OF ESTATES AND BENEFICIARIES, 525-33 (1970).

26. 1967-1 CUM. BULL. 194.

27. Treas. Reg. § 1.661(a)-1 (1956) defines a complex trust, in effect, as one which is required to and does distribute amounts other than income during the taxable year.

carries over the donor's basis.[28] Presumably this portion of the stock will still have the section 306 taint.

While the Internal Revenue Service might argue against the above results as violative of clearly determined congressional policy under the step transaction doctrine,[29] it is submitted that their arguments should fail. While it is true that Congress did not intend to create this loophole to remove the section 306 taint, the statute, and the Treasury's Regulations under it, mandate this result. One must take the statute as written, rather than as Congress might have written it had it discerned the potential problems. This trust is not a sham; that is, not created exclusively to hold the preferred stock as the holding of appreciating property was also necessary. Furthermore, the trust bears a true market risk. There is no guarantee that the potentially appreciable property will in fact appreciate or that the grantor's closely held corporation will remain solvent. Nor is the sale of the preferred stock prearranged. Thus, the typical characteristics of a step transaction, that is, interdependent steps subject to binding commitments,[30] are not present here.

There also exists the very viable possibility that the IRS would fight such a mechanism on the basis that a distribution of stock triggers a distribution of income. Such risks must, of course, be weighed when deciding whether potential gains merit use of this device.

In conclusion, the utilization of the Schnepper Trust in the above situation might remove the section 306 taint on the preferred stock, allow the shareholder through his son to take cash out of his corporation at capital gain rates, and potentially allow a sheltering of realized appreciation by the trust through a fair market value step-up deduction by the trust. It is a valuable weapon which should

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28. Rev. Rul. 64-314, 1964-2 CUM. BULL. 167.

29. For a discussion of step transactions, see generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 1-19 to 1-21 (1971); Comment, *Step Transactions*, 24 U. MIAMI L. REV. 60 (1969).

30. *See* Commissioner v. Gordon, 391 U.S. 83, 96 (1968).

be considered by any tax advisor who services closely held corporations and their owners.[31]

31. There are alternatives for removing the § 306 taint on the preferred stock outlined in § 306(b). As none of these alternatives are applicable in the instant case, they will not be discussed.

For a discussion of these alternatives, in depth analyses of § 306 and other ways to remove the taint, see generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ch. 10 (1971); Alexander & Landis, *Bail-Outs and the Internal Revenue Code of 1954*, 65 YALE L.J. 909 (1956); Dean, *Rules Governing Preferred Stock Bail-Outs*, 14 N.Y.U. INST. ON FED. TAX. 691 (1956); Kendal, *Section 306 Stock: How to Remove the "Taint" and Use It Effectively in Tax Planning*, 24 J. TAX. 322 (1966); Lowe, *Bailouts—Their Role in Corporate Planning*, 30 TAX. L. REV. 357 (1975); Solomon, *How to Deal With Section 306*, 1968 So. CAL. TAX. INST. 167; Young, *Preferred Stock Bail-Outs: Statutory Restrictions: Pitfalls and Continuing Opportunities Under the 1954 Code (Section 306)*, 15 N.Y.U. INST. ON FED. TAX. 431 (1957).