Clark v. Commissioner, 84 T. C. 644 (1985)

In corporate reorganizations, the Wright test should be used to determine if boot received by shareholders has the effect of a dividend, focusing on the hypothetical redemption of the acquiring corporation's stock.

Summary

In Clark v. Commissioner, Donald E. Clark, who owned all shares of Basin Surveys, Inc. (BASIN), exchanged his stock for a combination of cash and N. L. Industries, Inc. (NL) stock during a merger. The issue was whether the cash (boot) should be treated as a dividend or capital gain. The Tax Court held that under the Wright test, the cash received should be treated as capital gain because it represented a hypothetical redemption of NL stock, resulting in a significant reduction in Clark's interest in NL. The court's reasoning focused on preventing shareholders from bailing out corporate earnings at capital gains rates, emphasizing the reorganization's effect on the shareholder's interest in the acquiring corporation.

Facts

Donald E. Clark owned all 58 shares of Basin Surveys, Inc. (BASIN), a West Virginia corporation involved in petroleum industry services. N. L. Industries, Inc. (NL), a larger corporation, initiated discussions to acquire BASIN. NL offered Clark two alternatives: 425,000 shares of NL stock or a combination of 300,000 shares and $3,250,000 in cash. Clark chose the latter. On April 18, 1979, BASIN merged into N. L. Acquisition Corp. (NLAC), a wholly owned subsidiary of NL. Clark received the agreed-upon cash and stock, representing 0. 92% of NL's total shares post-merger. BASIN had accumulated earnings and profits of $2,319,611 at the time of the merger.

Procedural History

The IRS determined a deficiency in Clark's 1979 federal income taxes, treating the cash received as a dividend under Section 356(a)(2). Clark filed a petition with the Tax Court, arguing the cash should be treated as long-term capital gain under Section 356(a)(1). The Tax Court reviewed the case and ultimately held in favor of Clark, applying the Wright test to determine the tax treatment of the boot.

Issue(s)

1. Whether the cash (boot) received by Clark should be treated as a dividend under Section 356(a)(2) or as long-term capital gain under Section 356(a)(1)?

Holding

1. No, because under the Wright test, the cash payment is treated as a hypothetical redemption of NL stock, resulting in a significant reduction in Clark's interest in NL,

thus qualifying as capital gain under Section 356(a)(1).

Court's Reasoning

The court chose the Wright test over the Shimberg test to determine dividend equivalency, focusing on the effect of the reorganization on Clark's interest in the acquiring corporation (NL). The Wright test treats the cash payment as a redemption of what would have been additional NL stock if Clark had chosen the all-stock offer. This approach aligns with the legislative intent behind Section 356(a)(2) to prevent the bailout of earnings at capital gains rates, without automatically treating all boot as a dividend. The court noted that Clark's post-merger holdings in NL were reduced by approximately 29%, qualifying as a "substantially disproportionate" redemption under Section 302(b)(2). The court also emphasized the step-transaction doctrine, viewing the cash payment as part of the overall reorganization plan rather than a separate event.

Practical Implications

Clark v. Commissioner clarifies the application of the Wright test in determining the tax treatment of boot in corporate reorganizations. Practitioners should analyze the effect of the reorganization on the shareholder's interest in the acquiring corporation when assessing potential dividend equivalency. This decision impacts how mergers and acquisitions are structured, encouraging the use of stock rather than cash to avoid dividend treatment. It also highlights the importance of considering the entire reorganization plan, including any cash payments, under the step-transaction doctrine. Subsequent cases, such as General Housewares Corp. v. United States, have distinguished this ruling, particularly when there is no commonality of ownership between the acquired and acquiring corporations.

