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TAXATION — INCOME TAX — EXEMPT REORGANIZATIONS — WHEN IS A REORGANIZATION BONA FIDE UNDER THE RULE OF GREGORY v. HELVERING — An individual wished to buy certain patents from a corporation, and at his instigation, the corporation transferred them to a newly-organized patent holding company, which issued its shares directly to the stockholders of the transferor corporation. On discovery of disadvantages from this scheme, the buyer requested that the new corporation be dissolved and that the patents be assigned by the original patentee individually. Petitioner and all other shareholders sold their stock in the new corporation to the patentee in exchange for his notes, and he dissolved the corporation, receiving the patents on liquidation. The patents were then sold for cash, which was used to pay off the notes. Petitioner returned as capital gain her profit from the sale of the stock. The commissioner, who was upheld by the Board of Tax Appeals, contended that the organization and dissolution of the patent holding company should be ignored and that the distribution of patents be taxed as an ordinary dividend. *Held*, the transaction was a "reorganization" within the meaning of section 112 (i) (1) (B) of the Revenue Act of 1928 so that no gain was recognized on distribution to her of the stock of the new corporation in pursuance of the plan of reorganization. *Lea v. Commissioner of Internal Revenue*, (C. C. A. 2d, 1938) 96 F. (2d) 55, reversing 35 B. T. A. 243 (1937).

The revenue laws exempt from tax any capital gains arising from corporate reorganizations.[1] Crafty counsel have sought to use this exemption to arrange sales of corporate assets under the guise of reorganizations. However, the United States Supreme Court, in *Gregory v. Helvering*,[2] held that although there is technical compliance with the letter of the statutory definition of reorganization,[3] the benefit of the exemption will be denied unless the reorganization

[1] Sec. 112 (b) (4) of the Revenue Act of 1938, 52 Stat. L. 485, 26 U. S. C. A. (Supp. 1938), § 112 (b) (4). The instant case was decided under the Revenue Act of 1928, § 112 (g) and (i) (1) (B), 45 Stat. L. 818, 26 U. S. C. A. (1935), § 112, note, which provisions are substantially the same as the 1938 law.

[2] 293 U. S. 465, 55 S. Ct. 266, 97 A. L. R. 1355 at 1359 (1935). See Sandberg, "The Income Tax Subsidy to 'Reorganization,' " 38 COL. L. REV. 98 at 110 (1938), and notes in 48 HARV. L. REV. 852 (1935), 23 CAL. L. REV. 641 (1935), and 83 UNIV. PA. L. REV. 804 (1935), for discussions of the case.

[3] Sec. 112 (g) (1) of the Revenue Act of 1938, 52 Stat. L. 485, 26 U. S. C. A. (Supp. 1938), § 112 (g) (1): "The term 'reorganization' means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected."

is "of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either . . . ." [4] In this case the court denied the benefit of the exemption, since it was found that no business other than a transfer of assets and immediate dissolution was ever contemplated. Furthermore, the court intimated that it would look through any contrivance designed to use the reorganization provision for the purpose of escaping taxation. However, in subsequent cases the courts and the Board of Tax Appeals have tended to be liberal in their inquiry into motive by confining the *Gregory* case to its particular facts, and refusing to apply it if they find some evidence that the reorganization was not solely for the purpose of avoiding tax liability. In the instant case, the dissolution of the new corporation occurred less than a month after its formation. This led the Board of Tax Appeals to rely on the *Gregory* case. The court, however, distinguished it, saying: "If an intention to dissolve within three days existed when the patents were assigned . . . there would be a basis for the argument that the *Gregory* case was applicable. However, it is uncontradicted that there was no such intent, but the corporation was meant to operate as a patent holding corporation. . . ." [5] Transactions will not be held to be sham under the rule of the *Gregory* case so long as they are born of a purpose to achieve a revision of a business, even though accompanying motives related to tax saving may stand out boldly.[6] It is only what Judge Learned Hand calls a "ritualistic incantation" of reorganization whose sole purpose is to "fob" the treasury that is stricken down, as in the *Gregory* case, *Electrical Securities Corp. v. Commissioner*,[7] and *Marcher v. Commissioner*,[8] each of which contained an admission to that effect on the record. In *Chisholm v. Commissioner*,[9] a partnership was formed, admittedly to postpone or escape taxes, but it continued to do business up to the time of the suit. The court carefully pointed out that the subsequent business of the firm made the rule of the *Gregory* case inapplicable. Discussing the acts of the incorporators in the leading case, the court said: "Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped, whatever other aim they might have had, whether to avoid taxes, or to regenerate the world." In light of the principal case, it still remains to be seen how little business plus a tax-dodging motive the courts will tolerate. It is still very likely that nominal transactions which are obviously engaged in with a tax rather than commercial incentive will not earn the benefit of the reorganization exemption.

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[4] Gregory v. Helvering, 293 U. S. 465 at 469, 55 S. Ct. 266 (1935).

[5] Principal case, 96 F. (2d) 55 at 57.

[6] Judge Learned Hand, in Electrical Securities Corp. v. Commissioner, (C. C. A. 2d, 1937) 92 F. (2d) 593 at 595: "The purpose of the section is apparent; it was meant to allow businesses to be reconstructed when the resulting interests were substantially unchanged; but it presupposed that the enterprises were in fact businesses; financial, commercial, industrial, and the like. The avoidance or suspension of taxes is not a business. While this may introduce into the definition an element of purpose, it does not trench upon the doctrine that men may arrange their affairs with an eye to reducing or avoiding taxes; so they may, but they must conform to the terms of the statute and to understand these we need more than a dictionary."

[7] (C. C. A. 2d, 1937) 92 F. (2d) 593.

[8] 32 B. T. A. 76 (1935).

[9] (C. C. A. 2d, 1935) 79 F. (2d) 14 at 15, 101 A. L. R. 200.