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TAXATION — CAPITAL GAINS TAX (REVENUE ACT OF 1928) — REORGANIZATIONS — DEFINITION OF A PARTY TO A REORGANIZATION — Although "certainty" is one of the most desirable features of taxation, that quality has been conspicuously absent in regard to the portions of the 1928 Revenue Act which deal with capital gains in corporate reorganizations.[1] In the four situations which the act sets forth as constituting a reorganization, capital gains arising therefrom are exempt from tax computation, the general purpose being to remove any impediment to normal corporate adjustments and to prevent the recognition of gains or losses until they are actually realized.[2] However, this provision soon became an invitation for ingenious counsel to

[1] The relevant portions of the 1928 Revenue Act—45 Stat. L. 791—are:

Sec. 112 (b)(3): "No gain or loss shall be recognized if stock or securities in a corporation, a party to a reorganization, are, in pursuance of a plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

Sec. 112 (i)(1): "The term 'reorganization' means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) 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 stockholders or both, are in control of the corporation to which the assets have been transferred. . . ."

Sec. 112 (i)(2): "The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation."

[2] C. H. Mead Coal Co. v. Commissioner, (C. C. A. 4th, 1934) 72 F. (2d) 22. See Sandberg, "The Income Tax Subsidy to Reorganizations," 38 COL. L. REV. 98

arrange the sales of corporate assets in the form of reorganizations, thereby obtaining the benefit of an exemption never contemplated by the legislature. Although an obvious attempt at such practice was thwarted in at least one instance by the Supreme Court of the United States,[3] numerous doubtful transactions have caused a good deal of uncertainty as to what now constitutes a reorganization within the meaning of the act, especially under clauses (A) and (B) of section 112 (i)(1). Several of the major disputed issues will be briefly summarized.

It was first contended that clause (B) should be construed as a limitation upon the scope of the definition contained in clause (A). The statute reads as follows:

> "The term 'reorganization' means (A) a merger or consolidation including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), or (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both, are in control of the corporation to which the assets have been transferred. . . ."[4]

The argument was advanced that the words "merger or consolidation" were used in their ordinary sense, and generally referred to a situation where one corporation acquired practically complete control over another.[5] Consequently, it would not be sufficient to effect a reorganization if only a bare majority of the stock of another corporation were acquired, because commonly "reorganization" implied a much higher degree of control. It was argued that clause (B) was inserted to substantiate this interpretation of clause (A). However, this contention was completely refuted by the Circuit Court of Appeals for the Fourth Circuit in *Mead Coal Co. v. Commissioner*.[6] After ex-

at 100 (1938), for a review of the plausible reasons urged as a basis for exempting these particular transactions.

[3] Gregory v. Helvering, 293 U. S. 465, 55 S. Ct. 266 (1935), affg. (C. C. A. 2d, 1934) 69 F. (2d) 809. See Sandberg, "The Income Tax Subsidy to Reorganizations," 38 COL. L. REV. 98 at 110 (1938), for a discussion of the doctrine of this case.

[4] 45 Stat. L. 791 (1928), § 112 (i)(1). Cf. § 112 (j): "As used in this section the term 'control' means ownership 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 the corporation."

[5] Pinellas Ice & Cold Storage Co. v. Commissioner, (C. C. A. 5th, 1932) 57 F. (2d) 188.

[6] (C. C. A. 4th, 1934) 72 F. (2d) 22.

haustively tracing the legislative history of the act, the court concluded that the various additions and amendments in the Revenue Acts were intended to enlarge rather than restrict the scope of the section as a whole. Clause (A) was first found in the Act of 1921, and it was not until three years later that clause (B) became a part of the statute, with a purpose, as stated by the House Committee,[7] to *include* in a reorganization the situation in which there was a transfer of all or a part of the assets of one corporation to another, if after the transfer, the transferor should be in control. This view was essentially followed in *Helvering v. Minnesota Tea Co.*[8] The Circuit Court of Appeals for the Eighth Circuit there regarded as significant the fact that, in 1924, Congress did not merely amend clause (A) but "retained clause (A) . . . and specifically added a new clause, covering a different group of cases, clause (B)." This view was later affirmed by the Supreme Court of the United States[9] and can now be accepted as settled law.

Some doubt arose as to whether or not a dissolution was necessary in order to effectuate a reorganization as required by the statute. From the wording of the act it may be inferred that Congress could never have intended a dissolution, for it provided that a reorganization would occur when one corporation acquired at least a majority of all classes of stock of another, and certainly such a transaction would be insufficient ordinarily to bring about a dissolution of the selling corporation.[10] Nevertheless, the Board of Tax Appeals in *Watts v. Commissioner*[11] held there could be no "merger or consolidation" unless accompanied by a dissolution. The Circuit Court of Appeals for the Second Circuit reversed the holding of the Board and its decision was affirmed recently by the Supreme Court of the United States.[12] Numerous other cases compel the conclusion that a dissolution is not essential to a reorganization.[13]

[7] Ways and Means Committee, H. REP. 179, 68th Cong., 1st sess. (1924), p. 16: "Subdivision (h) (1) contains a definition of reorganization which corresponds to the definition contained in § 202 (c) (2) of the existing law. The only change in the definition is to include within its terms the case of 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 stockholders, or both, are in control of the corporation to which the assets are transferred. This is a common type of reorganization and clearly should be included within the reorganization provisions of the statute."

[8] (C. C. A. 8th, 1935) 76 F. (2d) 797 at 801.

[9] Helvering v. Minnesota Tea Co., 296 U. S. 378, 56 S. Ct. 269 (1935). See also Commissioner v. Western Power Corp., (C. C. A. 2d, 1938) 94 F. (2d) 563.

[10] See Hendricks, "Developments in the Taxation of Reorganizations," 34 COL. L. REV. 1198 at 1215 (1934).

[11] 28 B. T. A. 1056 (1933).

[12] Helvering v. Watts, (C. C. A. 2d, 1935) 75 F. (2d) 981, affd. 296 U. S. 387, 56 S. Ct. 275 (1935).

[13] C. H. Mead Coal Co. v. Commissioner, (C. C. A. 4th, 1934) 72 F. (2d)

Another dispute arose as to the effect of the parenthetical expression in clause (A)—was it intended to enlarge or to restrict the ordinary meaning of "merger or consolidation?" It reads:

> "(A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation). . . ."

It was always supposed that this expression was intended to expand the scope of those terms, especially since the phrase was introduced by the word "including" and not by the word "meaning," which most commonly indicates a non-exclusive interpretation.[14] However, the Circuit Court of Appeals for the Second Circuit, in *Pinellas Ice & Cold Storage Co. v. Commissioner*,[15] took a contrary view, indicating that a technical merger or consolidation was required regardless of the plain language of the parenthetical insertion. But this decision was reversed by the Supreme Court[16] and it is now fairly well agreed that the parenthetical expression expands the meaning of "merger or consolidation" so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words.[17]

In conjunction with the requisites already mentioned, another essential element to a reorganization gradually gained in emphasis; that is, continuity of interest on the part of the seller in the affairs of the purchasing company. Not that this factor is expressly required by the act, but rather it is implied from the general meaning of "reorganization."[18] But one must not be misled by the frequent stress placed upon this point and regard it as a separate and independent requisite of reorganization. It is merely one of the incidents to be considered in determining whether a given situation is more in the nature of a sale

22; Helvering v. Minnesota Tea Co., 296 U. S. 378, 56 S. Ct. 269 (1935); G. & K. Mfg. Co. v. Helvering, 296 U. S. 389, 56 S. Ct. 276 (1935); Commissioner v. Kitselman, (C. C. A. 7th, 1937) 89 F. (2d) 458.

[14] REGULATIONS 74 (Income Tax Law of 1928), art. 577.

[15] (C. C. A. 5th, 1932) 57 F. (2d) 188.

[16] Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U. S. 462, 53 S. Ct. 257 (1933).

[17] Groman v. Commissioner, 302 U. S. 82, 58 S. Ct. 108 (1937).

[18] Cortland Specialty Co. v. Commissioner, (C. C. A. 2d, 1932) 60 F. (2d) 937 at 940: "In defining 'reorganization' § 203 of the Revenue Act [1926] gives the widest room for all kind of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms."

than a genuine merger or consolidation;[19] for if from other evidences a genuine merger or consolidation is unmistakably present, only slight importance will be attached to the element of continuity of interest.[20] In short, a reorganization would occur under section 112 (a)(1)(A) if one corporation acquired a majority of all the stock of another in such a manner that the transferor had a continued interest in the affairs of the new company, regardless whether the transaction involved a dissolution or not.

Having determined when a reorganization has been effectuated, it would seem a relatively simple question to ascertain when a corporation is a party to a reorganization. The statute provides under section 112(i)(2):

> "The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation."[21]

It is agreed that the statutory definition is not exclusive but merely enumerates one instance of possible numerous situations.[22] Yet in *Commissioner v. Bashford*[23] the Third Circuit Court of Appeals differed sharply from the Supreme Court of the United States as to the meaning of this phrase. In that case *A* corporation decided to reorganize its three competitors into a new corporation, of which *A* corporation would acquire all the preferred and a majority of the voting stock. The circuit court held that *A* corporation was a party to the reorganization, and that shares of its stock received by the stockholders of the competitor companies, were exempt from the capital gains tax, in the same manner as were the shares received by them of the newly formed

[19] Helvering v. Minnesota Tea Co., 296 U. S. 378 at 385, 56 S. Ct. 269 (1935), after affirming the view taken in the Pinellas case requiring some continuity of interest, held, "and we now add that this interest must be definite and material; it must represent a substantial part of the thing transferred. This much is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation."

[20] In the case of John A. Nelson Co. v. Helvering, 296 U. S. 374, 56 S. Ct. 273 (1935), the Court regarded an exchange of preferred non-voting stock as conveying sufficient interest to the transferor in the affairs of the purchasing company to fulfill the requirements of a reorganization.

[21] 45 Stat. L. 791, § 112 (i) (2) (1928).

[22] Groman v. Commissioner, 302 U. S. 82, 58 S. Ct. 108 (1937): "The section [§ 112 (i)(2)] is not a definition but rather is intended to enlarge the connotation of the term 'a party to a reorganization'."

[23] (C. C. A. 3d, 1937) 87 F. (2d) 827. This court earlier expressed the same view in Commissioner v. Fifth Avenue Bank, (C. C. A. 3d, 1936) 84 F. (2d) 787.

company. But the Supreme Court reversed this decision,[24] purporting to follow its conclusion in the *Groman*[25] case, which involved a similar set of facts. There *A* and *B* corporations agreed that *A* corporation would form a new company which would acquire all the assets of *B* corporation; *B's* shareholders would receive in exchange for their old stock some shares of the new company, shares of *A* corporation, and cash. *A* corporation became owner of all the voting stock of the new company, but did not acquire any of its preferred stock. In both cases the Supreme Court held that *A* corporation was neither literally nor substantially a party to the reorganization.

Clearly the *A* corporation in the *Groman* case did not comply literally with section 112 (i)(2), for it failed to acquire a majority of all classes of stock in the new corporation. But this difficulty is not present in the *Bashford* case, wherein *A* corporation became owner of all the preferred and of fifty-seven per cent of the voting stock of the new company. Nevertheless, it might be contended in support of the view taken by the Supreme Court that two separate reorganizations were effected in the *Bashford* case: one between the three competitor companies and the new corporation, and the other between the latter corporation and *A* corporation. Thus, by dividing the transaction into two steps, it would appear that *A* corporation had no part in the first reorganization wherein the taxpayer received the shares of stock which are claimed to be exempt from the capital gains tax. But any argument based on this theory avoids a realistic interpretation of the facts, since the whole plan essentially involved only one reorganization with a single purpose of securing to *A* corporation control over its three competitors. The transactions in this case contemplated throughout not only the acquisition by the new company of substantially all the assets of the old companies; but also the acquisition by *A* corporation of a majority of all classes of stock of the new company itself. Consequently, any division of the transaction into separate steps is wholly arbitrary and without substance.

Another view of the situation in the *Bashford* case might lead to the conclusion that what had occurred was a consolidation of the three competitor companies into a newly formed corporation with *A* corporation taking no more part in the transaction other than becoming a stockholder in the latter corporation. Consequently, *A* corporation, formerly having no interest in the three old companies, could not be regarded as a party to the reorganization, since the essential element of continuity of interest would be lacking. However, this approach disregards the fact that *A* corporation did acquire a majority of all classes

[24] Helvering v. Bashford, (U. S. 1938) 58 S. Ct. 307.
[25] Groman v. Commissioner, 302 U. S. 82, 58 S. Ct. 108 (1937).

of stock of the new company, and further, that the interests of the shareholders of the three old companies were continued in *A* corporation as well as in its subsidiary. True, *A* corporation was an agent in company, but it also occupied another capacity; namely, that of a party to the reorganization in so far as it fulfilled the statutory requirements bringing about the consolidation, and was a stockholder in the new as interpreted by the courts. Granted that *A* corporation did not directly acquire a majority of all the stock of the three competitors, it had, nevertheless, acquired all the preferred and a majority of the voting stock of the new company, which, in turn, had assumed all the assets of the three competitor companies. Consequently, *A* corporation was one of "both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation."

But conceding for the moment that literal compliance with the statute was not accomplished, why were not the *A* corporations in both cases "parties to the reorganization" within the ordinary connotation of the clause? In both instances certainly the *A* corporations were the motivating forces in the exchange. They originated the idea, arranged the several transactions, invested their own capital and stock, and maintained a material interest in the result of the dealings. As properly characterized by the circuit court in the *Bashford* case, they were "the mainspring of the entire proceeding."[26] What further degree of connection with the transaction the Supreme Court would require of the *A* corporation is not easily perceived. Suppose in the *Bashford* case *A* corporation had merged with the three competitor companies at the outset, and then later formed a subsidiary of essentially the same nature, to which it transferred all the assets acquired by the merger. Would not the same result have been accomplished free of all doubt that *A* corporation was a party to the reorganization? If this is admitted, it seems unduly formal to tax the same transaction in another form merely because the desire to keep the identity of *A* corporation undisclosed prevented the suggested plan from being utilized.

The Circuit Court of Appeals for the Seventh Circuit was recently faced with essentially this situation in *Schuh Trading Co. v. Commissioner*.[27] In that case *A* corporation made an agreement with *B* corporation whereby the latter company was to transfer substantially all its assets to *A* corporation or its nominee in exchange for stock of *A*

[26] (C. C. A. 3d, 1937) 87 F. (2d) 827 at 830. See 24 VA. L. REV. 418 at 429 (1938) wherein the Groman and Bashford cases are regarded as adopting a formal view of the term "a party to a reorganization."

[27] (C. C. A. 7th, March, 1938) 95 F. (2d) 405.

corporation and a small amount of cash. The nominee to which the assets were transferred was a wholly owned subsidiary of *A* corporation. The circuit court, adhering to the view expressed in the *Bashford* case (although not referring to it), held that *A* corporation was clearly a party to the reorganization and the mere fact that the assets were transferred to its subsidiary, which was its representative, did not alter the situation. The *Groman* case was sought to be distinguished by emphasizing that therein *A* corporation transferred nothing at all directly to the stockholders of *B* corporation, but rather transferred its stock to the newly formed subsidiary which, in turn, transferred the same to the shareholders of *B* corporation. Does this fact alone serve to substantially differentiate the cases? Admitting that where the transfer is directly made, *A* corporation does appear more obviously to be a party to the reorganization, the situations are, nevertheless, essentially the same in so far as in both cases the motivating corporations have exchanged their stock to effectuate a transfer of the assets of other corporations to subsidiary companies. Whether there is ownership of all or merely a majority of the stock of the subsidiary companies is of no significance, for in either case it can be contended with equal force that, in receiving the newly acquired assets, the subsidiary company was acting as a representative, or on behalf of, *A* corporation. This being true, the position is unavoidable that the latter company was a party to the reorganization.

The problem might further be approached by inquiring into the possible intention of the legislature. Although the answer may be entirely conjectural, it would not seem improbable, in the light of the avowed purpose of the act not to interfere with normal business readjustments, that such a situation was intended to be included in the act. The general tendency of the Revenue Acts to cover transactions which are not technically mergers or consolidations would lead to a broad construction inclusive of the situation presented in the *Bashford* and *Groman* cases.[28]

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[28] The relevant portions of the 1934 Revenue Act are as follows, Sec. 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 part of its voting stock: of at least 80% of the voting stock and at least 80% of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation. . . ." Obviously the situation in the Groman and Bashford cases will not fall within the provisions of this act since this type of transaction is not ordinarily a statutory merger or consolidation, and since in the particular cases, 80% of the stock of the new company was not acquired. Moreover, the exchange does not appear to have been made for voting stock of the *A* corporations.