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TAXATION — FEDERAL INCOME TAX — STATUS OF STOCK-FOR-STOCK EXCHANGE WHERE BOOT IS INVOLVED—Taxpayer was the sole stockholder of International Dairy Supply Company. In 1952, Foremost Dairies, Inc. acquired from taxpayer all his stock in Supply Company in exchange for 82,375 shares of Foremost's common stock and 3,000,000 dollars cash. Taxpayer reported as gain from the transaction only the 3,000,000 dollars

"boot" received, less allowable expenses. The Commissioner determined a deficiency of 278,823 dollars, asserting that the nonrecognition provision of the 1939 Code counterpart of section 356 (a) (1) was inapplicable and therefore taxpayer's entire gain realized on the disposition must be recognized. The Tax Court upheld taxpayer's contention that by virtue of section 356 (a) (1), which provides that if the exchange would otherwise have been within the scope of section 354 (a) (1)—providing that no gain or loss shall be recognized in a stock-for-stock reorganization exchange—*but for* the receipt of "boot," the transaction is taxable only to the extent of the cash received.[1] On appeal, *held,* reversed. The applicability of section 354 (a) (1) in this case is predicated upon two "solely-for-stock" requirements. First, this transaction must meet the definitional "solely-for-stock" requirement of section 368 (a) (1) (B)[2] to receive the status of a "reorganization." Second, if the transaction is in fact a "reorganization," section 354 provides nonrecognition of gain if the exchange of stock is made "solely-for-stock." If section 354 "would apply to an exchange but for"[3] the failure to meet the "solely-for-stock" test of that section, the operative saving provision of section 356—which limits the tax to the gain not in excess of the boot—will apply. However, since this transaction does not, in the first instance, meet the definitional "solely-for-stock" requirement of section 368, section 354 can never apply. Therefore, section 356 is likewise not available to the taxpayer and he must recognize his entire gain. *Commissioner v. Turnbow,* 286 F.2d 669 (9th Cir. 1960), *cert. granted,* 366 U.S. 923 (1961) (No. 60).

Only those transactions defined in section 368 (a) (1) are cognizable as "reorganizations" for tax purposes. It is important to note that only in the (B)—"stock-for-stock," and the comparable (C)—"stock-for-assets"[4] defini-

[1] Grover D. Turnbow, 32 T.C. 646 (1959), *nonacq.* 1960—CUM. BULL. 7. Taxpayer argued that "but for" the boot involved, the exchange would have been within § 112 (b) (3) [§ 354 (a) (1)] which provides: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are . . . exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Int. Rev. Code of 1939, ch. 2, § 112 (b) (3), 53 Stat. 38 [now INT. REV. CODE OF 1954, § 354 (a) (1)]. Thus, he contended, it is taxable under § 112 (c) (1) [§ 356 (a) (1)] only to the extent of the boot received. "If an exchange would be within the provisions of subsection (b) . . . (3) . . . of this section if it were not for the fact that the property . . . consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain . . . if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." Int. Rev. Code of 1939, ch. 2, § 112 (c) (1), 53 Stat. 39 [now INT. REV. CODE OF 1954, § 356 (a) (1)].

[2] Int. Rev. Code of 1939, ch. 2, § 112 (g) (1) (B), 53 Stat. 40 [now INT. REV. CODE OF 1954, § 368 (a) (1) (B)], defines a "reorganization" as: "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 . . . stock of another corporation. . . ."

[3] INT. REV. CODE OF 1954, § 356 (a) (1) (A).

[4] Int. Rev. Code of 1939, § 112 (g) (1) (C), as amended, ch. 247, § 213 (b), 53 Stat.

tions of reorganizations is there the "solely-for-stock" requirement. It is in these cases alone that the question arises whether an exchange involving boot may qualify as a reorganization. As early as 1941 the Supreme Court, in *Helvering v. Southwest Consolidated Corp.*,[5] held that boot disqualified an attempted (C)-type reorganization. In that case all assets of an insolvent corporation were acquired for voting common stock, stock purchase warrants, and cash of the newly-formed acquiring corporation. The Court held the transaction did not qualify for the preferred tax status afforded a reorganization because it fell short of the literal definition of a reorganization in subparagraph (C) in that the assets of the transferor corporation were not acquired *solely* for voting stock.[6] For almost twenty years, the generally accepted view—based on the *Southwest* decision—was that a transaction also would not qualify as a (B)-type reorganization if part of the consideration for the exchange were cash or "other property" since the definitional provisions in both subparagraphs (B) and (C) contain the identical "solely-for-stock" requirement. However, in 1956 the Seventh Circuit in *Howard v. Commissioner*,[7] seemingly ignored the thrust of the *Southwest* decision and held that an exchange of stock-for-stock-plus-boot did qualify for preferred tax treatment under the savings clause of section 356 (a) (1)—the so-called "but for" provision. The decision, in effect, was that the saving provision of that section applied not only to the operative section 354 (a) (1) "solely-for-stock" requirement, but also to the independent, definitional section 368 (a) (1) (B) "solely-for-stock" requirement. The court reasoned that "but for" the cash boot distributed, the "solely-for-stock" requirement of the definitional provision in section 368 (a) (1) (B) would have been met, thus qualifying the transaction as a reorganization. Section 356 (a) (1) would then come into operation, preventing the entire transaction from being disqualified for the preferential nonrecognition treatment and requiring the recognition of gain only to the extent of the boot received. The court in the principal case limited the operation of section 356 (a) (1) to the "solely-for-stock" requirement of section 354 (a) (1). Now the question is again raised, and the Supreme Court will have the opportunity to reconsider and to re-evaluate its decision in the *Southwest* case.

To determine whether the interpretation in *Howard* or that given by the court in the principal case most clearly reflects the congressional purpose behind the provisions, the policy for allowing nonrecognition in

870 [now INT. REV. CODE OF 1954, § 368 (a) (1) (C)], defines a "reorganization" as: "the acquisition by one corporation, in exchange solely for all or a part of its voting stock, . . . of substantially all the properties of another corporation. . . ."

[5] 315 U.S. 194 (1942).

[6] The Court stated: "'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement." *Id.* at 198.

[7] 238 F.2d 943 (7th Cir. 1956).

reorganizations must be considered. It has been said that the primary concern is that business adjustments necessary to the economic health of the country would be discouraged if recognition of gains were required each time a substantial change was made in the form of a business structure.[8] To the end of facilitating business adjustments, Congress provided in the Revenue Act of 1918[9] that gain or loss realized in a "reorganization, merger, or consolidation" would not be recognized for tax purposes at the time of the transaction. Due to the vagueness of the above terms, it is doubtful whether business adjustments were really facilitated. It was not until the Revenue Act of 1934[10] that the provisions governing nonrecognition in reorganizations were solidified into what is substantially their present form. At that time, the preferred tax treatment was limited to the specific types of reorganizations defined in the statute. "Statutory" mergers or consolidations were defined, in subparagraph (A) of that forerunner of section 368 (a) (1), to be reorganizations. Because statutory mergers or consolidations were unavailable in some states, Congress provided that "stock-for-stock" and "stock-for-assets" exchanges would likewise be considered reorganizations under what are now subparagraphs (B) and (C).[11] It has been argued that this congressional intent will be thwarted by the interpretation adopted by the court in the principal case, since a small minority of dissident stockholders could always prevent an exchange from qualifying as a non-taxable reorganization.[12] This, however, is not correct. Congress has provided in the definitional provision itself that to effect a (B) reorganization only 80 percent[13] of the stock of the corporation need be

[8] See the now famous "Gregg Statement," N.Y. Times, Jan. 5, 1924, p. 1, col. 2 (Gregg was a special assistant to the Secretary of the Treasury); H. R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934); *cf.* Barker v. United States, 200 F.2d 223 (9th Cir. 1952). For a discussion rejecting this as a grounds for the grant of preferred tax status, see Hellerstein, *Mergers, Taxes, and Realism*, 71 HARV. L. REV. 254 (1957). Other supporting considerations are that generally, in a reorganization, there has not been a sufficiently final change in form to tax the exchange. See Gregg, *op. cit. supra*, p. 1; see generally Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98 (1938). Also, where a taxpayer has received little or no money through an exchange, collection of a tax on the entire amount of the gain would be inequitable since the taxpayer would not be in position to pay. H. R. REP. No. 179, 68th Cong., 1st Sess. 16 (1924), S. REP. No. 398, 68th Cong., 1st Sess. 17-18 (1924). It is doubtful, however, whether this is the rationale underlying the preferred treatment given reorganizations since the taxation of boot is not restricted to cash received but includes, under § 356 (a) (1), "other property." See Sandberg, *supra* at 100.

[9] Ch. 18, § 202 (b), 40 Stat. 1060.

[10] Ch. 277, § 112 (g) (1) (B), 48 Stat. 705.

[11] See S. REP. No. 558, 73d Cong. 2d Sess. 16-17 (1934), which states, in part: "Not all the states have adopted statutes providing for mergers or consolidations. . . . The committee believes it is desirable to permit reorganizations in such cases. . . . The committee believes that these transactions . . . are in themselves sufficiently similar to mergers and consolidations as to be entitled to similar treatment."

[12] See, *e.g.*, Howard v. Commissioner, 238 F.2d 943, 947 (7th Cir. 1956); Fahey, *Income Tax Definition of "Reorganization,"* 39 COLUM. L. REV. 933, 948 (1939).

[13] The requirement of § 112 (g) (1) (B) of the 1939 Code was acquisition of 80%

acquired.[14] It is thus seen that there need be no cash or "other property" exchanged in order to effect the reorganization. However, in an (A) reorganization (merger or consolidation) there is a need to permit a certain amount of boot to be exchanged because in at least thirty-three states "appraisal statutes" have been enacted under which stockholders who dissent from the plan of merger or consolidation are given the right to demand payment for the fair value of their shares.[15] Many "appraisal statutes" also specifically give stockholders the right to payment for their shares in case of an exchange of all the assets of the corporation—a (C)-type reorganization.[16] However, whether a state's "appraisal statute" includes such a provision or not, it is quite likely the transferor corporation, upon the exchange of substantially all its assets, will be dissolved, in which event the dissenting stockholders will be entitled to receive the fair value of their shares under the general provisions of such statutes.[17] There-

of the stock of the other corporation. Under the 1954 Code § 368 (a) (1) (B), the acquiring corporation must be in "control" of the other corporation immediately after the exchange. "Control" is defined as ownership of 80% of the stock of a corporation. INT. REV. CODE OF 1954, § 368 (c). Although the court in the principal case rejected the *Howard* rationale, it is possible to distinguish that case on its facts. In *Howard*, 80.19% of the stock of a corporation was acquired solely for stock. Had no more stock been acquired, the transaction would have qualified under § 112 (g) (1) (B) [§ 368 (a) (1) (B)] as a reorganization. It would thus have been entitled to tax free treatment under § 112 (b) (3) [§ 354 (a) (1)], "but for" the remaining stock which was acquired for cash. Since § 112 (b) (3) would apply "but for" the boot distributed, § 112 (c) (1) was held to operate thus preserving the transaction's reorganization status. In the principal case only 29% of the stock of Supply was acquired "solely-for-stock" of Foremost. Thus, "but for" the cash involved, Foremost still would not have acquired 80% of the stock of Supply solely for its own stock and so, it may be argued, the exchange could never qualify as a reorganization.

14 Even where the dissenters hold more than 20% in interest, a reorganization could be consummated if their shares were acquired for cash in a separate and independent transaction. However, the possibility would remain that the Commissioner might determine there had been only one transaction with two phases. See, *e.g.*, Halliburton v. Commissioner, 78 F.2d 265 (9th Cir. 1935). For a discussion of the problems which may arise in such exchanges under the 1939 Code and the 1954 Code, see Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX L. REV. 155, 160 & n.34 (1959).

15 See BALLANTINE, CORPORATIONS § 298 (rev. ed. 1946); Lattin, *Remedies of Dissenting Stockholders Under Appraisal Statutes*, 45 HARV. L. REV. 233, 237 (1931).

16 See BALLANTINE, *op. cit. supra* note 15, § 298; Lattin, *supra* note 15, at 248; *cf.* Ballantine & Sterling, *Upsetting Mergers and Consolidations: Alternative Remedies of Dissenting Shareholders in California*, 27 CALIF. L. REV. 644, 672 (1939) suggesting, under some statutes (similar to California's), that dissenting stockholders may have this right even where the general corporation statute did not specifically confer the power to exchange all the corporation's assets for stock of another corporation over objection of dissenting stockholders.

17 See note 15 *supra*. The transferor corporation ordinarily will be dissolved since if it is not, it will be subject to a tax on 15% of the dividends received from the acquiring corporation under § 243. Congress recognized the legal necessity to "buy off" dissenting stockholders and provided for it in the 1954 Code under § 368 (a) (2) (B). The House version of this provision, H.R. 8300, 83d Cong., 2d Sess. § 359 (c) (1954), would have *required* the liquidation of the transferor corporation and provided also that

fore, in both (A) and (C) reorganizations the requirement of cash payment to dissenting shareholders will often make the distribution of boot a practical necessity. However, there is no such justification for permitting it in (B) reorganizations since there is no legal compulsion to "buy off" dissident stockholders.[18] Another criticism leveled at the interpretation of the court in the principal case rests on possible effects under section 356 (c) of the 1954 Code. That section provides for nonrecognition of *losses* resulting from transactions that would qualify under section 354 (a) (1) "but for" the receipt of additional property not permitted under that section. If the existence of boot in an exchange prevents the exchange from being a reorganization so that section 356 (a) (1) does not apply and the entire amount of the *gain* must be recognized, then if there were a loss, section 356 (c) likewise would not apply and the entire loss could be recognized. Thus if only a small amount of cash or "other property" is received, the transaction will constitute a sale and taxpayer may recognize his entire loss.[19] There is no answer to this objection. However, whether the provisions will be subject to abuse may depend on the courts' willingness to extend the rationale of *Higgins v. Smith*.[20] In that case a loss claimed on the "sale" of marketable securities to a wholly-owned corporation was disallowed on the ground that the time and manner of taxation established by Congress could not be circumvented merely by the form in which a transaction was carried out if, in substance, no loss had been sustained.[21]

In addition to the practical considerations discussed above, the statutory history of the (C) reorganization provision supports the result reached in the principal case. Prior to the enactment of the 1954 Code, the assets of the transferor corporation had to be acquired "solely-for-stock."[22] New section 368 (a) (2) (B) of the 1954 Code was adopted solely to modify this by providing that a stock-for-assets-plus-boot exchange may still qualify as a (C) reorganization so long as 80 percent of the property

if 80% of the transferor corporation's assets were acquired "solely-for-stock," the remainder could be acquired for cash. The Senate modified this by deleting the requirement that the transferor corporation be dissolved. See S. REP. No. 1622, 83d Cong., 2d Sess. 274 (1954). However, if the transferor corporation is not dissolved, and if dividends are not paid, the threat of the penalty tax of § 531 is imminent.

18 *But see* Ayers & Repetti, *Boot Distributions Under the '54 Tax Code*, 32 NOTRE DAME LAW. 414, 419 (1957), suggesting there is no sound reason for prohibiting boot in a (B) reorganization and that the court in *Howard* reached an "equitable result."

19 The actual amount of loss deduction would be limited by § 1211 (b). However, the "loss" could still be used to immunize any gains which the taxpayer might have realized during the year.

20 308 U.S. 473 (1940).

21 *Cf.* Burnet v. Commonwealth Improvement Co., 287 U.S. 415 (1932) (gain on sale by corporation to sole stockholder recognized).

22 Int. Rev. Code of 1939, § 112 (g) (1) (B).

acquired is acquired "solely-for-stock."[23] The *Howard* interpretation would permit a stock-for-stock-plus-boot and, presumably, a stock-for-assets-plus-boot exchange to qualify in the absence of the new section 368-(a) (2) (B), and thus would render that provision superfluous.

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[23] See S. REP. No. 1622, 83d Cong., 2d Sess. 52 (1954).