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TAX-FREE CORPORATE ACQUISITIONS—THE LAW AND THE PROPOSED REGULATIONS*

Robert L. Merritt†

The king cried aloud to bring in the astrologers, the Chaldeans, and the soothsayers. And the king spake, and said to the wise men of Babylon, Whosoever shall read this writing, and show me the interpretation thereof, shall be clothed with scarlet, and have a chain of gold about his neck, and shall be the third ruler in the kingdom.

DANIEL 5:7

THE quest for interpretation is indeed an ancient one. Our life path is pervaded by a search for meanings.

It has been said of the law that it is sometimes better to have a bad rule than to have no rule. I suppose the rationale is that unsatisfactory certainties at least permit action, and are susceptible to a change for the better, the very badness of the rule serving to accelerate the equitable resolution. Being neither philosopher nor historian, I do not know whether that patience which awaits ultimate improvement is always a virtue.¹

Two tools of the practicing lawyer in dealing with the affairs of his clients are the Internal Revenue Code and the Treasury Regulations which, to paraphrase the learned judge, are the administrative moons reflecting the light of the statute. In a measure, the writer and enforcer of the Regulations is the "third ruler in the kingdom." The Congress enacts the law, and the courts are the last resort² of interpretation and application. In between lies great responsibility.³

* This article is based in part on a paper, "Tax-Free Acquisition of Corporate Business" which was delivered by the author on November 9, 1954 at the New York University 13th Annual Institute on Federal Taxation. The proceedings of that Institute are published by Matthew Bender & Company, Albany, New York.

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¹ Cf. Justice Reed's dissenting opinion in *Commissioner v. Estate of Sternberger*, 348 U.S. 187 at 200-201, 75 S.Ct. 229 (1955): "There is a certain hesitation in dissenting from an interpretation of a tax statute remediable by Congress, but as the Court's decision springs, we think, from an overemphasis on regulations, a protest may have usefulness as a counterweight against future extensions of such treatment to statutory language."

² Pending, of course, a further round when the Congress enacts additional or remedial legislation.

³ The Internal Revenue Service should be ever mindful that "unless the tax asserted by the Commissioner has been authorized by Congress, it fails of validity. . . ." *Helvering v. Griffiths*, 318 U.S. 371 at 394, 63 S.Ct. 636 (1943).

The Bar is particularly concerned at this time that this responsibility be conscientiously fulfilled. Fortrightness in interpretation should cause no one to fear the lion's den.

This article will illustrate, by reference to some aspects of the new "B" (corporate acquisition of stock) and "C" (corporate acquisition of property) reorganization definitions, instances in which the impatient practitioner would replace proposed certainties (or neglected or inadvertent uncertainties) with more seemly interpretations.

Corporate mergers and acquisitions are part of the dynamics of the business world. The financial pages report the increasing rate at which mergers and other corporate acquisitions are being effected. The strengthening of the economy through these means, subject to the restraints and philosophy of the antitrust laws, is generally to be encouraged.⁴ Since 1918 the tax law has contained rules causing the nonrecognition of gain or loss realized as a result of such corporate transactions.⁵ The particular rules governing nonrecognition have been changed over the years,⁶ and periodically a reexamination has been made of the directions chosen and the effectiveness of the statutory solutions.

The preparation of H.R. 8300⁷ offered a splendid opportunity to the Congress and the Treasury to reexamine the reorganization provisions of the 1939 code with a view toward clarifying uncertainties in meaning, writing into the statute some of the products of judicial decision and remedying by clear language the occasional harsh imprints on the body of law which have resulted therefrom. Unfortunately, the

⁴BUTTERS, LINTNER AND CARY, *EFFECTS OF TAXATION—CORPORATE MERGERS*, c. 1 (1951), discuss opposing viewpoints as to whether recent merger activity is significantly promoting industrial concentration and monopoly. The book analyzes the effect of taxes on the sale of profitable closely held companies. See also REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY THE ANTITRUST LAWS (March 31, 1955); REPORT OF THE FEDERAL TRADE COMMISSION ON CORPORATE MERGERS AND ACQUISITIONS (May 1955).

⁵The Revenue Act of 1918, §202(b) provided certain nonrecognition rules in the case of a "reorganization, merger or consolidation." No definition of these terms appeared in the statute until §202(c)(2) of the Revenue Act of 1921 was enacted.

⁶See 3 MERTENS, *LAW OF FEDERAL INCOME TAXATION*, c. 20 (1942 and 1954 Supp.); PAUL, *STUDIES IN FEDERAL TAXATION*, Third Series, 1-165 (1940). See also H. Rep. 1337, 83d Cong., 2d sess., p. 34 (1954).

⁷H.R. 8300, as passed by the House of Representatives on March 18, 1954, will be referred to as the "House Bill," and as passed by the Senate on July 2, 1954 will be referred to as the "Senate Bill." H.R. 8300, as passed by Congress on July 29, 1954 and enacted into law on August 16, 1954 as P.L. 591, 83d Cong., 2d sess., will be referred to as the "Internal Revenue Code of 1954," "1954 code" or "I.R.C. (1954)." The prior law will be referred to with 1939 designations. See I.R.C. (1954), §7701(a)(29). If no code designation is indicated, the 1954 code is meant.

reach exceeded the grasp; the result of the legislative effort has been to multiply the uncertainties. The fault is not all in the statute; the interpretation thereof is wanting. The Proposed Regulations under section 368 (the "reorganization" definitions section) deal with the new areas of doubt by either ignoring their existence or resolving them in favor of recognition of gain or loss. The first course, while disappointing, is not affirmatively harmful. The solutions obtained through the second course warrant reconsideration by the Treasury.

I. "NET EFFECT" AND "STEP TRANSACTION" PROBLEMS

The House Bill and the accompanying Ways and Means Committee Report are keys to the proper interpretation of section 368.⁸ This is so even though the House Bill abandoned the familiar reorganization terminology and introduced entirely new concepts. Much of the substance of the House Bill with respect to corporate acquisitions of stock⁹ or property¹⁰ was continued in modified form in the Senate Bill, and was enacted as the "B"¹¹ and "C"¹² reorganization definitions.

The Ways and Means Committee had admirable objectives, one of which was to make the law sufficiently definite to permit taxpayers to ascertain in advance the tax consequences of their actions when effecting corporate distributions and adjustments. The House Bill was designed to promote clarity and certainty and "to insure that the same tax consequences result from the different types of transactions which are available to accomplish substantially the same result."¹³ Taxpayers were to be prevented from in effect choosing the type of tax for which they would be liable through a choice of one road rather than another to the same destination.

The Senate Finance Committee agreed with the above objectives, but balked at the House Bill solutions. It felt that the House Bill achieved certainty at the sacrifice of the legislative flexibility needed to

⁸ The history of how the House Bill came into being and the extent of the influence of the Income Tax Project of the American Law Institute on that bill is discussed in Darrell, "The Internal Revenue Code of 1954," 1955 SOUTHERN CALIFORNIA TAX INSTITUTE 1 (1955). See American Law Institute, Federal Income, Estate and Gift Tax Project, COMPARISON OF THE AMERICAN LAW INSTITUTE FEBRUARY, 1954 INCOME TAX DRAFT AND 1954 INTERNAL REVENUE CODE, p. 20 (February 1, 1955).

⁹ House Bill, §359(b).

¹⁰ House Bill, §359(c).

¹¹ I.R.C. (1954), §368(a)(1)(B).

¹² I.R.C. (1954), §368(a)(1)(C).

¹³ H. Rep. 1337, 83d Cong., 2d sess., p. 39 (1954). See also p. 34. H. Rep. 1337 is hereinafter referred to as "House Report."

provide an equitable statutory pattern for taxing the numerous varieties of corporate reorganizations.¹⁴

It is surprising, in view of these expressions of intent, to find that the Proposed Regulations under section 368 fail to mention the possible application of a "net effect" test or the "step transaction" rule either generally, or in connection with specific situations, such as those discussed below. Continuing in substance the language of the Regulations¹⁵ which interpret the 1939 code, the Proposed Regulations¹⁶ provide, "Section 368(a)(1) limits the definition of the term 'reorganization' to six kinds of transactions and excludes all others. From its context, the term 'a party to a reorganization' can only mean a party to a transaction *specifically* defined as a reorganization by section 368(a). . . . A plan of reorganization must contemplate the bona fide execution of one of the transactions *specifically* described as a reorganization in section 368(a) and for [*sic*] the bona fide consummation of each of the requisite acts under which nonrecognition of gain is claimed. . . ."¹⁷ This is a strong brew of "specificallys," made even stronger by the further statement in the Proposed Regulations¹⁸ that "The application of the term 'reorganization' is to be strictly limited to the specific transactions set forth in section 368(a). . . ."

If there were not a history of the courts applying a "net effect"¹⁹ test, and of the Internal Revenue Service itself urging such a test in particular cases, this would be troublesome language indeed. But even so, the problem is not a simple one and requires some attention. Primarily, if there is to be a net effect test contended for by the Service and applied by the courts, the Regulations should leave some leeway for the application of such a test. The Regulations should not be written so as to be disregarded on suitable occasions. In addition, where does the taxpayer stand where the convenient and direct path is not "specifically" spelled out in the statute or the Regulations, but

¹⁴ S. Rep. 1622, 83d Cong., 2d sess., pp. 41-42 (1954). S. Rep. 1622 is hereinafter referred to as "Senate Report."

¹⁵ Treas. Reg. 118, §39.112(g)-1.

¹⁶ Proposed Regulations §1.368-1(c). The Proposed Regulations were published in the *Federal Register* on December 11, 1954.

¹⁷ Italics supplied. This provision may have originally been based on the statutory statement that "the term 'reorganization' *means*" etc. See Hendricks, "Federal Income Tax: Definition of 'Reorganization,'" 45 HARV. L. REV. 648 at 650 (1932), which observes that "The use of this word probably indicates that the definition shall not be susceptible of expansion or addition. . . ."

¹⁸ Proposed Regulations, §1.368-2(a). See also Proposed Regulations, §1.368-2(g).

¹⁹ See Mintz and Plumb, "Step Transactions in Corporate Reorganizations," N.Y.U. 12TH ANNUAL INSTITUTE ON FEDERAL TAXATION 247 at 250 (1954), which refers to this as an "end result" test, under which a given intended result will have the same tax effect

the inconvenient and roundabout route clearly meets one of the reorganization definitions? Does getting to Scotland on the low road require the giving up of (nonrecognition) rights which accompany the taking of the high road?

A. *The Groman and Bashford Rules*

The "net effect" problems created by the 1954 code, which the Proposed Regulations leave unresolved in some instances and which they unsatisfactorily resolve in others, can be illustrated by examples of the operation of the revised *Groman*²⁰ and *Bashford*²¹ rules.²²

In the *Groman* case Glidden Company formed an Ohio corporation and became the owner for a cash consideration of all of its common stock. Pursuant to an agreement contemplating such action, to which agreement Glidden was a party, the shareholders of an Indiana corporation transferred all their shares of stock in that corporation to Ohio in exchange²³ for the latter's nonvoting 6 percent cumulative preferred stock, 7 percent prior preferred stock of Glidden, and cash. After Ohio acquired all of Indiana's outstanding stock, the latter was dissolved. Ohio thus coming into possession of all of Indiana's assets.²⁴ The issue in the case was whether the receipt of the Glidden 7 percent prior preferred stock by Indiana's shareholders constituted taxable income to them, it being conceded that the receipt of Ohio's preferred stock did not and that the receipt of the cash did.

whether achieved directly or by circuitous steps. The authors consider this to be a refinement of the "step transaction" doctrine that a single transaction cannot be broken up into its component steps.

²⁰ *Groman v. Commissioner*, 302 U.S. 82, 58 S.Ct. 108 (1937), opinion amended and rehearing den. 302 U.S. 654, 58 S.Ct. 108 (1937).

²¹ *Helvering v. Bashford*, 302 U.S. 454, 58 S.Ct. 307 (1937).

²² See also Merritt, "Tax-Free Acquisition of Corporate Business," N.Y.U. 13th ANNUAL INSTITUTE ON FEDERAL TAXATION 693 (1955); Lurie, "Namorg—Or *Groman* Reversed," 10 TAX L. REV. 119 (1954).

²³ The Supreme Court, in the *Groman* case, originally stated that the shareholders of Indiana received nothing from Glidden. The record was not clear as to whether Indiana's shareholders received the Glidden stock from Glidden or from Ohio. The taxpayer petitioned for a rehearing on the ground, unsupported by the record, that the stock was received from Glidden. Apparently to eliminate any implication that this factor was important to its decision, the Supreme Court corrected its opinion by deleting the statement. *Groman v. Commissioner*, 302 U.S. 654, 58 S.Ct. 108 (1937). See *Lawrence v. Commissioner*, 7th Cir. 1941) 123 F. (2d) 555 at 558; *Michigan Steel Corp. of New Jersey*, 38 B.T.A. 435 at 451 (1938), appeal dismissed (6th Cir. 1940) 116 F. (2d) 280; PAUL, *STUDIES IN FEDERAL TAXATION*, Third Series, 107 (1940).

²⁴ Under the Revenue Act of 1928, §112(i)(1)(A), these transactions qualified as a "reorganization" because there was "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, or substantially all the properties of another corporation. . . ."

It was unanimously held that Glidden, although it contracted for the exchange and made it possible by subscribing and paying for Ohio's common stock in cash so that Ohio could consummate the exchange, was *not* a party to the reorganization, for it received nothing from the shareholders of Indiana, the exchange being between Indiana's shareholders and Ohio. The Supreme Court characterized Glidden as merely "the efficient agent in bringing about a reorganization. It was not, in the natural meaning of the term, a party to the reorganization."²⁵ Moreover, the shareholders of Indiana, through ownership of Glidden preferred stock, did not retain a "continued substantial interest" in the assets conveyed to Ohio. Further, said the Supreme Court, Glidden's preferred stock was "other property" "in the sense that its ownership represented a participation in assets in which Ohio, and its shareholders through it, has no proprietorship." Accordingly, the receipt by Indiana's shareholders of Glidden's preferred stock was treated as the receipt of boot.

The failure of the Supreme Court to find the requisite continuity of interest of Indiana's shareholders in the assets transferred to Ohio, through their ownership of Glidden prior preferred stock, was indeed unfortunate.²⁶ The *Groman* decision and its progeny, with their unduly narrow application of the "continuity of interest" doctrine, stymied many a desired reorganization. It was generally recognized that a legislative reversal was necessary.²⁷ The 1954 code has offered some relief, but either due to a faulty analysis of the problem or to the haste in which the Senate Bill was written, some further legislative relief is still required. Moreover, since the Proposed Regulations ignore the "net effect" test, even areas in which Congress has acted will require judicial or statutory clarification unless the final Regulations adopt a more reasonable approach.

To facilitate an analysis of the 1954 code provisions, and the Proposed Regulations thereunder, I will first outline some of the factual patterns in which the *Groman* and *Bashford* and related cases arose. (It should be borne in mind in considering the examples that the facts have been considerably simplified, and that some of the cases arose under statutes which treated the *actual* transactions involved as "reorganizations," although under present definitions they would not so qualify.)

²⁵ 302 U.S. 82 at 89, 58 S.Ct. 108 (1937).

²⁶ For criticisms of the *Groman* decision, see Lurie, "Namorg—Or *Groman* Reversed," 10 TAX L. REV. 119 at 123-124 (1954); MAGILL, TAXABLE INCOME, rev. ed., 160 (1945); PAUL, STUDIES IN FEDERAL TAXATION, Third Series, 119-121 (1940).

²⁷ See PAUL, STUDIES IN FEDERAL TAXATION, Third Series, 121 (1940).

Example 1: Corporation *P* wishes to acquire all the assets of Corporation *W*. Corporation *P* forms a new subsidiary, Corporation *A*, to which the shareholders of Corporation *W* transfer all their stock in exchange for voting stock of Corporation *P*. Corporation *W* is then dissolved.²⁸

(a) The Corporation *W* shareholders receive the Corporation *P* stock from Corporation *A*.

(b) The Corporation *W* shareholders receive the Corporation *P* stock from Corporation *P*.²⁹

Example 2: The same facts as in Example 1(b), except that Corporation *P* receives the Corporation *W* stock and then as part of the plan of reorganization, or within the contemplation thereof, transfers it to Corporation *A*, so that Corporation *P* has momentary possession of Corporation *A*'s stock.³⁰

Example 3: Corporation *W* transfers all its assets to Corporation *A* in exchange for voting stock of the latter's parent, Corporation *P*. Corporation *W* distributes the Corporation *P* stock to its shareholders and dissolves.³¹

(a) Corporation *W* (or its shareholders) receives the Corporation *P* stock from Corporation *A*.

(b) Corporation *W* (or its shareholders) receives the Corporation *P* stock from Corporation *P*.

Example 4: The same facts as in Example 3 (b), except that Corporation *P* receives the Corporation *W* assets and then as a part of the plans of reorganization, or within the contemplation thereof, transfers them to Corporation *A*, so that Corporation *P* has momentary possession of Corporation *W*'s assets.³²

²⁸ *Groman v. Commissioner*, 302 U.S. 82, 58 S.Ct. 108 (1937). Cf. *Lawrence v. Commissioner*, (7th Cir. 1941) 123 F. (2d) 555.

²⁹ See note 23 *supra*.

³⁰ This is essentially the difference in facts between the *Bashford* and *Groman* cases. Cf. *Gertrude B. Chase*, 44 B.T.A. 39 (1941) (reviewed) non-acq. 1941-1 Cum. Bul. 13; 1942-1 Cum. Bul. 20, *affd. per curiam* (2d Cir. 1942) 128 F. (2d) 740; *Commissioner v. Kahn*, (6th Cir. 1942) 133 F. (2d) 199. In both of these cases Corporation *P* temporarily put Corporation *W*'s stock in the possession of Corporation *A*; Corporation *P* was held to be a party to the reorganization.

³¹ *Hedden v. Commissioner*, (3d Cir. 1939) 105 F. (2d) 311, cert. den. 308 U.S. 575, 60 S.Ct. 117 (1939), rehearing den. 308 U.S. 636, 60 S.Ct. 172 (1939); *Davis v. United States*, (Ct. Cl. 1939) 26 F. Supp. 1007, cert. den. 308 U.S. 574, 60 S.Ct. 90 (1939); *Neidlich v. Commissioner*, (3d Cir. 1939) 105 F. (2d) 1019, cert. den. 308 U.S. 599, 60 S.Ct. 130 (1939); *Michigan Steel Corp.*, 38 B.T.A. 435 (1938), appeal dismissed (6th Cir. 1940) 116 F. (2d) 280; *Park & Tilford*, 43 B.T.A. 348, 374, 375 (1941) (reviewed); *Richard K. Mellon*, 12 T.C. 90 (1949), *affd. on another issue* (3d Cir. 1950) 184 F. (2d) 157.

³² *Anheuser-Busch, Inc. v. Helvering*, (8th Cir. 1940) 115 F. (2d) 662, cert. den. 312 U.S. 699, 61 S.Ct. 739 (1941).

Example 5: Corporation *W* transfers all its assets for 80 percent of the common stock of Corporation *A*, only common being issued and outstanding. Corporation *W*, as part of the plan of reorganization, or within the contemplation thereof, then transfers the stock of Corporation *A* thus received by it, for voting stock of Corporation *P*, which thereupon becomes the parent of Corporation *A*. Corporation *W* distributes the Corporation *P* stock to its shareholders and dissolves.³³

Example 6: The same facts as in Examples 2 or 4, except that the second transfer is not part of the plan of reorganization or a contemplated variant thereof, but is an independent transaction and not an essential (or indeed any) part of the plan.³⁴

The above examples are simplified for the purposes of this discussion by having Corporation *W* or its shareholders receive only voting stock of Corporation *P*, and no other stock or cash or other property. Under section 354(a) and its predecessors³⁵ no gain or loss is recognized (with certain limitations not pertinent at the moment) "if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." In each of the above examples, other than example 6, Corporation *P* was held *not* to be a party to a reorganization, and the receipt of its stock was treated as the receipt of "boot."

B. *The Revised Groman and Bashford Rules*

It is not clear exactly how far the Congress intended to go with respect to offering legislative relief. The Ways and Means Committee Report states, "Your committee eliminates the technical requirements of existing law that the corporation cannot acquire assets in a merger in exchange for the stock of its parent[,] thus *overruling Groman* . . .

³³ *Whitney Corp. v. Commissioner*, (8th Cir. 1939) 105 F. (2d) 438; *United Light & Power Co. v. Commissioner*, (7th Cir. 1939) 105 F. (2d) 866, cert. den. 308 U.S. 574, 60 S.Ct. 90 (1939); *Commissioner v. First Nat. Bank of Altoona*, (3d Cir. 1939) 104 F. (2d) 865; *American Light & Traction Co.*, 42 B.T.A. 1121 (1940) (non-acq.), affd. on other grounds (7th Cir. 1942) 125 F. (2d) 365. But cf. *Ballwood Co. v. Commissioner*, (3d Cir. 1936) 84 F. (2d) 733.

³⁴ *Robert Campbell*, 15 T.C. 312 (1950) (acq.). See Mintz and Plumb, "Step Transactions in Corporate Reorganizations," N.Y.U. 12TH ANNUAL INSTITUTE ON FEDERAL TAXATION 247, 252 (1954).

³⁵ I.R.C. (1939), and the Revenue Acts of 1938, 1936, 1934, 1928, §112(b)(3).

and . . . *Bashford*. . . ”³⁶ Referring to another aspect of the problem, the Report states that under the House Bill “a corporation may acquire assets for immediate transfer to a controlled subsidiary, or may arrange for the transfer of the assets directly from the transferor corporation to such subsidiary, thus *changing* present law under . . . *Groman* . . . and . . . *Bashford*. . . ”³⁷ The Senate Committee Report adds nothing significant to this language,³⁸ except that it refers to the new rule which deals with the first aspect of the problem as *modifying*³⁹ rather than *overruling* *Groman* and *Bashford*.

The ultimate test, of course, is what the statute provides. The “C” reorganization definition has been modified by adding thereto the parenthetical expression in section 368(a)(1)(C), which would permit the acquisition by one corporation of substantially all of the properties of another corporation, “in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation)” In addition, section 368(a)(2)(C) specifically provides that a transaction otherwise qualifying as an “A” or a “C” reorganization is not disqualified as such “by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.”

In addition to the modification of the “C” reorganization definition in the manner indicated above, the “party to a reorganization” definition has been expanded to include Corporation *P* where Corporation *A* acquires substantially all of the properties of Corporation *W* in exchange for a part or all of the voting stock of Corporation *P*, the

³⁶ House Report, p. 40. Emphasis added. The SUMMARY OF H.R. 8300, THE PROPOSED INTERNAL REVENUE CODE OF 1954 AS PASSED BY THE HOUSE OF REPRESENTATIVES, which was prepared for the use of the Senate Committee on Finance by the technical staff of the Joint Committee on Internal Revenue Taxation, makes the remarkable statement that the House Bill “eliminates a formality of existing law.” See Hearings Before the Committee on Finance, United States Senate, 83d Cong., 2d sess., part I, p. 34 (April 7 and 8, 1954). Perhaps here is the key to why the statute leaves so many loose ends—its drafters may not have had time to study fully the problem and its ramifications. See text to note 109 *infra*, indicating a situation where the *Groman* decision may be far from “overruled.”

³⁷ Page A134. Emphasis added.

³⁸ The Senate Bill, §368(a)(2)(C), however, did extend the House Bill rules “to include a case where the parent corporation receives the assets in a statutory merger or consolidation and immediately transfers part or all of the assets to a subsidiary.” Senate Report, p. 52.

³⁹ *Id.* at 273. See also SUMMARY OF THE NEW PROVISIONS OF THE INTERNAL REVENUE CODE OF 1954 (H.R. 8300) AS AGREED TO BY THE CONFEREES (PUBLIC LAW 591, 83d CONG.), prepared by the Staff of the Joint Committee on Internal Revenue Taxation, p. 44 (1955).

latter being in "control"⁴⁰ of Corporation A. While not spelled out in the statute it would appear that the stock of Corporation P can move directly from that corporation to Corporation W or its shareholders, without first being transferred by Corporation P to Corporation A.⁴¹

1. *Acquisition of stock and liquidation of subsidiary.* Whether the 1954 code merely "modifies" or in fact "overrules" the *Groman* and *Bashford* decisions is a critical question. An obvious defect of the statute is its failure specifically to apply the new rules to "B" reorganizations. Thus, where Corporation W stock received by Corporation P in a "B" reorganization is transferred by Corporation P to its wholly-owned subsidiary, Corporation A, as part of the plan of reorganization or within the contemplation thereof, the receipt by Corporation W shareholders of Corporation P voting stock will result in a taxable transaction.⁴² This may also be so even where Corporation W is forthwith dissolved pursuant to the plan (the *Bashford* case!). Likewise, a direct transfer to Corporation A of Corporation W stock in exchange for voting stock of Corporation P, Corporation W then being dissolved (the *Groman* case!), may not qualify as a tax-free exchange. Indeed, of the examples set forth above, the new rules only apply specifically to change the results in examples 3 and 4. Nevertheless, it is probable that the courts will extend the new rules to cover examples 1, 2 and 5 as well. Since the end results in examples 1 through 5 are identical, the tax consequences should not be different. The statute should have been drafted to so provide in clear terms. As it is, taxpayers will have to rely upon a "step transaction" or "net effect" approach to have examples 1, 2 and 5 ruled to be "C" reorganizations.

⁴⁰ Because I.R.C. (1954), §368(c) defines "control" to mean "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation," the above rules apply only where the relationship of Corporation P and Corporation A is as so defined. In a transaction where there is any lesser degree of control of Corporation A by Corporation P, the *Groman* and *Bashford* rules continue to govern.

⁴¹ In *Davis v. United States*, (Ct. Cl. 1939) 26 F. Supp. 1007, the Court of Claims held that the delivery by Corporation P of its stock directly to Corporation W was, "in legal contemplation," the same as the issuance by Corporation P of its stock to Corporation A and the delivery by Corporation A of Corporation P's stock to Corporation W in exchange for the latter's assets. Cf. note 23 *supra*.

Query whether the basis of the assets acquired will depend upon which route is chosen to get Corporation P and Corporation A stock into the hands of Corporation W or its shareholders, or to get Corporation W assets into the hands of Corporation A.

⁴² ALI Draft, §X601(c) and (d) provides a more desirable rule. Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, p. 311, illustrates the proposed rule as follows: "... assume Corporation A owns 10 per cent of the shares of Corporation X and Corporation B, which is in control of Corporation A, owns 30 per cent of

A step transaction approach has thus far been taken by the courts,⁴³ so that where liquidation of a newly acquired subsidiary is part of a plan to acquire its assets, the preliminary exchange of stock will be disregarded and the transaction will be viewed as a corporate acquisition of assets. A somewhat troublesome feature, however, is that the Proposed Regulations completely ignore the problem. Moreover, the Internal Revenue Service has never withdrawn its non-acquiescence in the *Whittell*⁴⁴ case, despite a reliance upon that case in subsequent litigation where its result has been helpful to the government's position.⁴⁵ Also, there is some intimation in the Ways and Means Committee Report⁴⁶ that a step transaction rule may not ordinarily be applied where a "corporate acquisition of stock" is followed by a "subsequent immediate liquidation" of the corporation whose stock is acquired. It would have been well if a specific statement had been

the shares of X. The shareholders of X may transfer 25 per cent [or more] of their shares to A and 15 per cent [or more] to B. Likewise, on the other side of the transaction, the stock acquired by the transferring shareholders may be received directly by a corporation controlled by them."

⁴³ See *George Whittell & Co.*, 34 B.T.A. 1070 (1936) (reviewed) non-acq. 1937-1 Cum. Bul. 53 and 1939-2 Cum. Bul. 72; *Mente & Co.*, 24 B.T.A. 401 (1931) (reviewed); *Tennessee, Alabama & Georgia Ry. Co.*, 13 T.C. 486 (1949) (reviewed), affd. (6th Cir. 1951) 187 F. (2d) 826; *WAGE, Inc.*, 19 T.C. 249 (1952); *Ahles Realty Corp. v. Commissioner*, (2d Cir. 1934) 71 F. (2d) 150, cert. den. 293 U.S. 611, 55 S.Ct. 141 (1934); *Commissioner v. Dana*, (3d Cir. 1939) 103 F. (2d) 359 (alternate holding under 1928 act). See also White, "Avoiding Pitfalls in Acquiring a Subsidiary Under Section 112(g)(1)(B)," N.Y.U. 8TH ANNUAL INSTITUTE ON FEDERAL TAXATION 193 at 200 (1950); Mintz and Plumb, "Step Transactions in Corporate Reorganizations," N.Y.U. 12TH ANNUAL INSTITUTE ON FEDERAL TAXATION 247 at 283 (1954); 3 MERTENS, LAW OF FEDERAL INCOME TAXATION §20.76 (1942). Cf. I.R.C. (1954), §334(b)(2), which treats a corporate acquisition of stock by "purchase," followed by a liquidation of the acquired corporation, as a direct purchase of the assets of the acquired corporation for purposes of determining the basis to the transferee of the acquired assets. *Kimbell-Diamond Milling Co. v. Commissioner*, (5th Cir. 1951) 187 F. (2d) 718, affirming 10 T.C. 7 (1948), cert. den. 342 U.S. 827, 72 S.Ct. 50 (1951).

⁴⁴ Note 43 supra. It is not clear why these are two non-acquiescences in this case, which involved a taxable year prior to the enactment of the tax-free liquidation of a subsidiary provision. See Revenue Act of 1934, §112(b)(6), as added by 1935 Act, §110; 1936 Act, 1938 Act and I.R.C. (1939), §112(b)(6); I.R.C. (1954), §332.

⁴⁵ E.g., *Tennessee, Alabama & Georgia Ry. Co.*, 13 T.C. 486 (1949), affd. (6th Cir. 1951) 187 F. (2d) 826.

⁴⁶ House Report, p. A128, first full paragraph, indicating a need for a special basis rule to get a "step transaction" result. See also Senate Report, p. 48, re the codification of the *Kimbell-Diamond* rule by I.R.C. (1954), §334(b)(2). See note 43 supra.

Cohen, Silverman, Surrey, Tarleau and Warren, "The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations," 68 HARV. L. REV. 393 at 415, n. 167 (1955), find "an appreciable amount of indirect support" for a "step transaction" rule in a passage in the Conference Committee Report [H. Rep. 2543, 83d Cong., 2d sess., at 41 (1954)]. Taxpayers may find less comfort than do the five authors in the passage, which deals with a tax avoidance device (liquidation followed by reincorporation).

made in the Ways and Means or Senate Finance Committee Reports⁴⁷ to the effect that it is intended that the new "party to a reorganization" rules cover step transactions having the effect of "C" reorganizations.⁴⁸ Perhaps the final Regulations will recognize the existence of the "step transaction" rule so that a corporate acquisition of assets which is immediately preceded by a corporate acquisition of stock will benefit from the statutory alleviation of the harsh *Groman* and *Bashford* rules.

2. *Division of transferred assets between parent and subsidiary corporation in "C" reorganization.* That the statutory modification of the *Groman* and *Bashford* rules was not adequately accomplished by the legislative draftsmen is further indicated by the provision that a transaction otherwise qualifying under the "C" reorganization definition shall not be disqualified "by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation⁴⁹ controlled by the corporation acquiring such assets."⁵⁰ It would appear from a strict reading of this language that Corporation P must be used as a conduit if it is desired to transfer part of Corporation W's assets to Corporation P and the remainder to Corporation A; a transfer directly to Corporation A of part of Corporation W's assets

⁴⁷ Cf. Statement of A. W. Gregg, Special Assistant to the Secretary of the Treasury, prepared for the use of the members of the House Committee on Ways and Means, in connection with the Treasury Draft of the Revenue Bill of 1924:

"A corporation in connection with a reorganization may dispose of its assets in one of three ways: It may transfer them to a new corporation in exchange for stock or cash; it may transfer them to the new corporation, the consideration being the payment by the new corporation of stock or cash to the stockholders of the old corporation; or the new corporation may buy, with its stock and cash, from the stockholders of the old corporation their stock, and then liquidate the old corporation. . . . subdivision (E) [predecessor to I.R.C. (1954), §361(b)] has been so drafted that the tax liability on the selling corporation is the same, no matter which of the three methods set out above is adopted. . . ." *THE NEW YORK TIMES*, January 5, 1924, p. 8:4.

⁴⁸ Cf. I.R.C. (1954), §368(a)(2)(A), which specifically treats "C" reorganizations which also meet the "D" requirements as "D" reorganizations; ALI Draft, §X601(b), discussed in Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, pp. 310-311, which requires that a transaction be treated as a recapitalization rather than a "B" reorganization wherever the shareholders of a transferor corporation have "a 50 per centum stock interest" [the Comment at p. 311 refers to this as "voting control"] of the acquiring corporation immediately after the transaction. The term "stock interest" is defined in ALI Draft, §X500(f).

⁴⁹ Query whether "a corporation" must be read "a single corporation," or whether it can be read "a corporation or corporations." Cf. *Tulsa Oxygen Co.*, 18 B.T.A. 1283 (1930), a pre-*Groman* decision, where Corporation A transferred its assets to Corporations C, D and E, subsidiaries of Corporation B, under a contract with Corporation C, for shares of stock in Corporation B, paid by Corporation D. The Board of Tax Appeals held that this was a tax-free reorganization, implying that Corporation B was a party thereto. See *Commissioner v. Fifth Avenue Bank of New York*, (3d Cir. 1936) 84 F. (2d) 787 at 789.

⁵⁰ I.R.C. (1954), §368(a)(2)(C).

and a transfer to Corporation P of the remainder may not qualify as a "C" reorganization, and gain or loss may be fully recognized in such a transaction.⁵¹

The distinction between a direct and an indirect transfer of part of Corporation W's assets to Corporation A can be a real one to the corporations involved. It is one which cannot easily be dismissed, even apart from the unreasonable duplication of real estate transfer taxes and other burdens which may be occasioned by an indirect transfer. For example, there may be provisions in a loan agreement which would prevent any transfer of the parent's fixed assets without the lender's approval, and in particular cases such approval may not be forthcoming. Perhaps in such a situation, where the assets of Corporation W are to be divided between a parent and a subsidiary, a net effect⁵² or inverse step transaction rule may permit the solution (where non-tax circumstances require this course) of Corporation W first transferring its entire assets to Corporation A, and then Corporation A immediately transferring a part of those assets to Corporation P. This approach is favored by at least two court decisions under prior law, although it perhaps may not be available now because of the precise language used in the 1954 code.

In *Gertrude B. Chase*⁵³ Republic Steel Company desired to obtain a controlling stock in interest in Truscon Steel Company. Because of a restriction in a mortgage on Republic's property, Republic found it could not *directly* acquire the stock of Truscon Steel without thereby preventing the latter from issuing securities or borrowing money. Republic therefore formed a new subsidiary, Truscon Holding Company, to acquire and hold the stock of Truscon Steel (thus avoiding applica-

⁵¹ ALI Draft, §X602(d) presents a more sensible rule. Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, p. 315, illustrates the proposed rule as follows: "Under this Draft, Corporation A may transfer all or part of its properties to Corporation B and the remainder to Corporation C which is in control of Corporation B in exchange for . . . C's shares. It will be noted, however, that under this Draft the transferor may receive only stock of the parent." An equivalent provision (applying only where Corporation B is wholly owned by Corporation C) was contained in §125 of H.R. 7738, 81st Cong., 2d sess. (1950), introduced by Representative Camp at the request of the Tax Section of the American Bar Association. See the discussion in Part IV *infra* as to whose stock may be received.

⁵² Cf. *Gunby, Inc. v. Helvering*, (D.C. Cir. 1941) 122 F. (2d) 203; *Thurber v. Commissioner*, (1st Cir. 1936) 84 F. (2d) 815; *Walter S. Heller*, 2 T.C. 371, 383 (1943), *affd.* (9th Cir. 1945) 147 F. (2d) 376, *cert. den.* 325 U.S. 868, 65 S.Ct. 1405 (1945). But cf. *Woodworth v. Commissioner*, (6th Cir. 1955) 218 F. (2d) 719. See the statement of Judge Hill, made in another connection, in *Herbert G. Hanan*, 3 T.C.M. 670 at 672, July 7, 1944: ". . . If a bridge is out [standing] to a traveler going from north to south, it is likewise out [standing] to a traveler going from south to north."

⁵³ 44 B.T.A. 39 (1941) (reviewed) non-acq. 1941-1 Cum. Bul. 13; 1942-1 Cum. Bul. 20, *affd. per curiam* (2d Cir. 1942) 128 F. (2d) 740.

tion of the restriction) until the restriction was terminated through the satisfaction of the mortgage. Pursuant to an exchange offer the taxpayer turned over her stock in Truscon Steel to Truscon Holding Company and received in exchange therefor stock of Republic. About a year later, after the mortgage was satisfied, Truscon Holding Company was merged into Republic. Truscon Steel was thereafter operated as a subsidiary of Republic.

The *Chase* case decided that the temporary holding of the Truscon Steel stock by Republic's wholly-owned subsidiary did not prevent the treatment of the exchange as a nontaxable reorganization. The Board of Tax Appeals found that the intermediate step whereby Republic's subsidiary held the Truscon Steel stock was merely transitory, and was to be given no weight. This decision was affirmed per curiam by the Second Circuit. The same result was reached by the Sixth Circuit in the companion *Margaret Kahn*⁵⁴ case, which relied in part "upon the application of principles discussed by us in *Commissioner v. Ashland & Refining Co.* . . ." In other words, a "net effect" and "step transaction" rule was applied—the substantial result which was intended by both parties to the transaction, and which in fact was effectuated, was a transfer of stock to Republic.

Suppose that in the *Chase* case it had been the intention of Republic to acquire all of the assets of Truscon Steel and then to transfer a part of such assets to a newly-formed subsidiary. Should the fact that non-tax considerations would cause Republic to alter the mechanics of the transaction and have the newly-formed subsidiary first receive the assets, with a transfer to Republic at the earliest opportunity of those assets wanted by Republic, cause the transaction to fall outside of the new "C" reorganization definition? Since the Internal Revenue Service still nonacquiesces in the result in the *Chase* case and the Proposed Regulations ignore the existence of a net effect rule, apparently certainty will be achieved readily only through a clarifying amendment to the statute. It would appear that Congress never intended in this situation to spell out a detailed order of transfers, for such an attempt "would make it difficult for necessary business transactions to be carried out with a minimum degree of interference from the tax laws."⁵⁵

3. *Assumption of liabilities of transferor in "C" reorganization.* Another aspect of the net effect problem appears in the application of

⁵⁴ *Commissioner v. Kahn*, (6th Cir. 1942) 133 F. (2d) 199.

⁵⁵ Cf. Senate Report, p. 42.

the assumption of liability provisions governing *Groman*-type "C" reorganizations. There is a "C" reorganization where substantially all of the assets of Corporation *W* are transferred to Corporation *P* in exchange for voting stock of Corporation *P* and the assumption of Corporation *W*'s liabilities by Corporation *P*, even though the latter forthwith transfers all or a part of Corporation *W*'s assets to Corporation *A*.⁵⁶ The assumption of Corporation *W*'s liabilities in such circumstances does not prevent the exchange from being treated as an exchange of assets "solely" for voting stock. However, should the statutory language be explicitly followed there would be no transfer of assets "solely" for voting stock if the assets of Corporation *W* are transferred *directly* to Corporation *A* and if Corporation *P* (in order to "dress up" the subsidiary's balance sheet, for example) assumes the liabilities of Corporation *W* in addition to giving its voting stock. Nevertheless, since one procedure has received legislative sanction, a less cumbersome and more direct procedure having the same net result should a fortiori be permitted. The Proposed Regulations do not find a constructive indirect⁵⁷ transfer in such cases. This is regrettable, for if a parent is permitted to assume a liability of the transferor in a two-step transaction but not in a one-step transaction, there will be situations where reorganizations will be unduly complicated and costly, and in some instances prevented entirely, because of the artificial tax strictures of section 368(a) as so interpreted.

The other side of the coin is that unless the same end result arrived at by different routes has a uniformly applied tax consequence, section 368(a)(1)(C) may provide a loophole where the transferor corporation or its shareholders sustains a loss upon the transfer. The transferor may be able deliberately to cause the loss to be recognized through the device of transferring substantially all of its assets directly to a subsidiary whose parent assumes the transferor's liabilities, such as its accounts payable, unsecured notes payable or debentures.⁵⁸ The courts have said on numerous occasions that the substance of a transaction, rather than its mere form, controls tax liability. "A given result at the end of a straight path is not made a different result because reached by following a devious path."⁵⁹ But here it is the devious

⁵⁶ I.R.C. (1954), §368(a)(1)(C) and (2)(C).

⁵⁷ Cf. *Davis v. United States*, (Ct. Cl. 1939) 26 F. Supp. 1007, note 41 supra; *Gertrude B. Chase*, 44 B.T.A. 39 (1941), note 53 supra.

⁵⁸ There are of course other ways in which recognition of loss can be achieved by the transferor or its shareholders. Because of the new 80%-20% rule of I.R.C. (1954), §368(a)(2)(B), it is somewhat more difficult than under the 1939 code to achieve this result through the giving of some "boot" to the transferor.

⁵⁹ *Minnesota Tea Co. v. Helvering*, 302 U.S. 609 at 613, 58 S.Ct. 393 (1938).

(two-step) path which the words of the statute requires for non-recognition of loss (or gain). A sensible interpretive approach would be to prevent a recognized loss from being achieved where a transaction takes a straight (one-step) path which reaches the same destination as does the long way round. It would avoid controversy and litigation if the situation were clarified by future legislation.

II. ACQUISITION OF STOCK "SOLELY" FOR VOTING STOCK

The 1939 code⁶⁰ defined a "B" 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 voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation" The House Bill⁶¹ substituted for this the concept of a "corporate acquisition of stock," which it defined, subject to two limitations, as "the acquisition in a single transaction, by one corporation, in exchange for all or part of its participating stock,⁶² of stock of another corporation" The first limitation required that "immediately after the acquisition the acquiring corporation has 'control' of such other [acquired] corporations (whether or not such acquiring corporation had control immediately prior to the acquisition)." The second required that a "relative size" (also called the "4 to 1") requirement be met.⁶³

⁶⁰ Section 112(g)(1)(B).

⁶¹ Section 359(b). Cf. American Law Institute Income Tax Project, February 1954 Draft, §X601, entitled "Corporate Acquisitions of Stock."

⁶² "Participating stock," as defined in House Bill, §312(b), was generally the garden variety of common stock, whether voting or nonvoting. See House Report, p. A98. Thus, the House Bill did not contain a solely for voting stock requirement.

Cf. American Law Institute Income Tax Project, February 1954 Draft, §§X601(a) and X602(a), which drop the solely for voting stock requirement of the "B" and "C" reorganization definitions in favor of a voting or nonvoting stock requirement. Although the Reporters view the "solely" for voting stock rule as "inconsequential," they deem the proportion of total voting stock held after the transfer by the shareholders of the transferor as "significant." As they phrase it, "it is believed that where the percentage of voting power in the acquiring corporation represented by the exchanged shares exceeds a certain figure, the transaction may properly be viewed as a reorganization rather than as a sale. . . . While a decision of this sort is necessarily arbitrary, . . . [20%] commends itself as most indicative of the fact that a reorganization, rather than a sale, has occurred." Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, p. 312. See also p. 309.

An alternative provision in the February 1954 Draft is that a corporate acquisition of stock or property will qualify as a reorganization regardless of changes in voting power if the transferors receive stock valued at 20% or more of the value of all the acquiring corporation's outstanding stock, for "where a corporation exchanges stock of its own of a sufficiently high value for the stock [property] of a second corporation, the transaction may properly be viewed as a reorganization rather than a single purchase by the acquiring corporation from the transferors. . . ." Id. at pp. 309-310, 313.

⁶³ This requirement attempted to come to grips with the "continuity of interest"

A "B" reorganization under the 1954 code is in essence a "corporate acquisition of stock" under the House Bill, but without the "relative size" requirement, and without a specific reference to the stock being acquired in "a single transaction."⁶⁴ Section 368(a)(1)(B) defines as a "reorganization"

" . . . the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control⁶⁵ of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)"

The parenthetical expression, retained from the House Bill, is the so-called "creeping control" amendment. In effect, the "creeping control" amendment treats as acquired in exchange for voting stock, for "B" reorganization purposes, any stock of a corporation which is acquired by another corporation prior to the transaction which results in the latter acquiring (solely for its voting stock) sufficient additional

problem by providing a statutory definition. See SUMMARY OF H.R. 8300, THE PROPOSED INTERNAL REVENUE CODE OF 1954 AS PASSED BY THE HOUSE OF REPRESENTATIVES, which was prepared for the use of the Senate Committee on Finance by the technical staff of the Joint Committee on Internal Revenue Taxation, Hearings Before the Senate Committee on Finance, 83d Cong., 2d sess., on H.R. 8300, Part 1, pp. 1, 33 (April 7 and 8, 1954). It was rejected by the Senate Finance Committee after strong opposition voiced at the Hearings on H.R. 8300 held before that committee. See, for example, Statement of Thomas N. Tarleau, Chairman, Section of Taxation, American Bar Association, Hearings Before the Committee on Finance, United States Senate, 83d Cong., 2d sess., on H.R. 8300, Part 1, p. 325 et seq. (April 7 and 8, 1954); Statement of the Chamber of Commerce of the United States on H.R. 8300, Hearings Before the Committee on Finance, 83d Cong., 2d sess., on H.R. 8300, Part 4, pp. 1945, 1956-1957 (April 22 and 23, 1954).

It is interesting to note that the Ways and Means Committee Report nowhere mentions the "continuity of interest" requirement in connection with corporation acquisitions of stock or property. Neither does the Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, pp. 311-315, with respect to ALI Draft, §X602 ("C" reorganizations), although it specifically states at p. 311 that "no continuity of interest" rule is superimposed upon ALI Draft, §X601 ("B" reorganizations). See note 62 supra. See also Cohen, Surrey, Tarleau and Warren, "A Technical Revision of the Federal Income Tax Treatment of Corporate Distributions to Shareholders," 52 COL. L. REV. 1 at 47 (1952).

⁶⁴ This last omission was probably due to an oversight. Cf. Senate Report, p. 273.

⁶⁵ I.R.C. (1954), §368(c) defines "control" as "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation." (Italics supplied.) Thus, the extent of the stock required to be obtained in a "B" reorganization under the 1954 code differs somewhat from the 1939 code requirement.

Note that 80% of each class of voting stock of the acquired corporation is not needed. As to nonvoting stock, only 80% of the total number of shares of all classes of nonvoting stock is needed, without regard to fair market values. Cf. Comment, February 1954 Draft, American Law Institute Income Tax Project, Vol. II, pp. 309-310, discussing ALI Draft, §X601(a)(2). See note 62 supra.

shares of the former to give it "control." Stated more simply, if Corporation A purchases 30 percent of the common stock (the only class of stock outstanding) of Corporation W for cash in 1955, and thereafter in a separate transaction in 1956 acquires an additional 60 percent of the common stock of Corporation W for its own voting stock, no gain or loss will be recognized with respect to the exchange in 1956 because the "B" reorganization requirements will be met. Under the 1939 code, this would not have been so because the original 30 percent had not been acquired solely for Corporation A's voting stock.⁶⁶

The Senate Finance Committee obviously intended to liberalize the old law by extending the scope of the "B" reorganization definition. However, the Proposed Regulations narrow the interpretation made by the old Regulations in an important respect.⁶⁷

The 1939 code required the acquisition "of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of other classes of stock of another corporation," and *such acquisition* had to be solely for all or a part of the voting stock of the acquiring corporation. The Regulations⁶⁸ under the 1939 code merely require that the acquisition by the acquiring corporation "of the required amount of the stock" of the acquired corporation "must be in exchange *solely* for all or a part of the *voting stock* of the acquiring corporation." Presumably, if in a single transaction Corporation A acquired 80 percent of Corporation W's common stock (the only class outstanding) for part of its own voting stock, it could acquire additional shares of Corporation W's common stock for cash without prejudicing the treatment of the transaction as a "B" reorganization. In fact, the

⁶⁶ Robert A. Pulfer, 43 B.T.A. 677 (1941), *affd.* (6th Cir. 1942) 128 F. (2d) 742. Cf. Mahlon D. Thatcher, 46 B.T.A. 869 at 880-881 (1942), *revd.* on other grounds *sub nom.* Commissioner v. Huntzinger, (10th Cir. 1943) 137 F. (2d) 128.

⁶⁷ In addition, Proposed Regulations, §1.368-3(a) perpetuate the (to my mind) erroneous interpretation of Treas. Reg. 118, §39.112(g)-6, that the corporation whose stock is being acquired must actually adopt the plan of reorganization. This requirement, which has no statutory basis, first appeared in Treas. Reg. 86, art. 112(g)-6(a) (1934 Act). That the Proposed Regulations are invalid is evident from the discussion in *Groman v. Commissioner* [302 U.S. 82 at 87, 58 S.Ct. 108 (1937)] of 1928 Act, §112(i)(2), which corresponds to I.R.C. (1954), §368(b)(2) ("Indiana, as such, was not a party to any agreement and took no corporate action." Nevertheless Indiana was found to be a "party to the reorganization."). But cf. Mahlon D. Thatcher, note 66 *supra*. See Merritt, "Tax-Free Acquisition of Corporate Business," N.Y.U. 13TH ANNUAL INSTITUTE ON FEDERAL TAXATION 693 at 725-727 (1955) for a further discussion of this problem.

⁶⁸ Treas. Reg. 118, §39.112(g)-2(c). This provision first appeared in Treas. Reg. 86, art. 112(g)-2, interpreting the 1934 Act. Cf. *Stockton Harbor Industrial Co. v. Commissioner*, (9th Cir. 1954) 216 F. (2d) 638 at 645, *cert. den.* (U.S. 1955) 75 S.Ct. 581: "The only properties which can be considered are those exchanged,—one for the other." ("C" reorganization.)

Senate Finance Committee Report seems to recognize this by stating that under the 1939 code one corporation could "acquire *enough stock* of another corporation to get control of the second corporation solely for its own voting stock" under a tax-free "B" reorganization.⁶⁹ Nevertheless, as we shall see, the described result was uncertain under the 1939 code.

The 1954 code presents its own problems of interpretation. Section 368(a)(1)(B) describes a general situation, i.e., the acquisition, in exchange solely for all or a part of the voting stock of an acquiring corporation, of stock of another corporation. It then states that such an exchange will constitute a "B" reorganization "if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)." This is interpreted by the following example given in section 1.368-2(c) of the Proposed Regulations: "If, for example, Corporation X, in one transaction exchanges nonvoting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of⁷⁰ stock of Corporation Y, the transaction is not a reorganization under section 368(a)(1)(B)."

It would appear that a justifiable and perhaps more proper interpretation of section 368(a)(1)(B) is the following: "If in one transaction Corporation X exchanges all or a part of its voting stock in the acquisition of stock of Corporation Y, which acquisition gives Corporation X 'control' of Corporation Y, then the transaction will be treated as a reorganization under section 368(a)(1)(B) even though in the same or a previous or later transaction Corporation X acquires or acquired additional shares of stock of Corporation Y for its nonvoting preferred stock or bonds, or cash or other boot."

If the Treasury should ultimately accept this interpretation, it may seek to put an overall limitation on "creeping control" situations by providing that if in the transaction which the taxpayer wishes to qualify as a "B" reorganization there is boot given in exchange for a part of the stock of Corporation Y, then there will be a "B" reorganization

⁶⁹ Emphasis added. No authoritative interpretation indicates whether the 80% control could be acquired through the "tacking on" of several acquisitions made solely for voting stock, but the consensus seems to be that it could. See Cohn, "What Is Meant by 'Control Immediately After the Transfer' in the Tax-Free Reorganization and Exchange Provisions?" N.Y.U. 8TH ANNUAL INSTITUTE ON FEDERAL TAXATION 129 at 133 (1950); Darrell, "Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954," 32 TAXES 1007 at 1012-1013 (1954). Cf. Hendricks, "Federal Income Tax: Definition of 'Reorganization,'" 45 HARV. L. REV. 648 at 654-655 (1932) (1928 Act).

⁷⁰ At this point Treas. Reg. 118, §39.112(g)-2(c) contain the words "the required amount of." See note 68 *supra*.

only if the stock constituting "control" was *in fact* acquired solely for voting stock of Corporation X. However, to be consistent in interpretation, it would seem that even here the prior acquired stock should be treated under the 1954 code as if acquired solely for voting stock, and that in the transaction which the taxpayer seeks to qualify as a "B" reorganization only sufficient additional stock to constitute "control" need be acquired solely for voting stock of Corporation Y. Of course, only the latter transaction would constitute an exchange as to which gain or loss is not recognized. The import of the "single transaction" concept in such a situation would be that only such stock as is acquired solely for voting stock in the single transaction which brings about "control" would be exchanged tax-free. Caution would indicate the avoidance of a single transaction wherein both voting stock and boot is given by Corporation X, and where the stock of Corporation Y acquired solely for voting stock of Corporation X is not sufficient in itself to bring about a meeting of the "control" definition.

Because of the intent to liberalize the "B" and "C" reorganization definitions by the 1954 code, interpretations made of earlier law with respect to the acquisition "solely" for voting stock requirement are not to be regarded as precedents in interpreting section 368(a)(1)(B). Moreover, it is my opinion that the only court decision under prior law which deals with the particular phase of that requirement under discussion here is inconclusive if not incorrect. In *Commissioner v. Air Reduction Co.*⁷¹ Corporation A acquired all 132,299 shares of Corporation W's outstanding stock through acquiring 87,275 shares for its own voting stock and 7,906 shares for cash prior to 1935, and acquired 14,771 shares for cash and 22,347 shares for its own voting stock (treasury shares) in 1935. Although 82.6 percent of Corporation W's shares were acquired for voting stock, the Second Circuit, reversing the Board of Tax Appeals, held that the acquisition of the 22,347 shares did not constitute a "B" reorganization under the 1934 Act and that Corporation A realized gain on the exchange of its treasury shares.

The Second Circuit's opinion was predicated principally on the ground that Corporation A was dealing in its treasury shares as it would in the shares of another corporation.⁷² However, it also held to be untenable the taxpayer's alternative contention that there was a

⁷¹ (2d Cir. 1942) 130 F. (2d) 145, revg. and remanding 1941 P-H B.T.A. Mem. Dec. ¶41,266, May 19, 1941, cert. den. 317 U.S. 681, 63 S.Ct. 201 (1942).

⁷² Cf. *Firestone Tire & Rubber Co.*, 2 T.C. 827 (1943), appeal to 6th Circuit dismissed June 19, 1944. But see I.R.C. (1954), §§362(b) and 1032.

"B" reorganization, for according to the Second Circuit the statutory definition under the prior law "contemplates only situations where the exchange is made 'solely' for voting stock. Here over 17 percent of the Pure Carbonic stock was purchased for cash. Cf. *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194, 62 S. Ct. 546. . . ."⁷³

The comparison of the facts in the *Air Reduction* case with those in *Southwest Consolidated* was not an apt one. Southwest Consolidated Corporation had acquired *all* the properties of a bankrupt corporation in exchange for a part of its voting stock, stock warrants, and the payment of cash to certain creditors of the bankrupt corporation. The cash was raised during the reorganization on a loan from a bank. The Supreme Court held that under the particular facts, the substance of the transaction was precisely the same as if Southwest Consolidated had paid cash plus voting stock and stock warrants for the properties. Moreover, the stock warrants which were issued were held not to be "voting stock." There was thus no meeting of the applicable reorganization requirement that *substantially all the properties* of one corporation be acquired *solely* for all or a part of the voting stock of the acquiring corporation.

Some recent decisions indicate that had substantially all the transferor corporation's property in the *Southwest Consolidated* case been acquired solely for voting stock of the acquiring corporation, with an inconsequential portion of the properties of the transferor being used to satisfy the claims of nonassenting creditors, a "C" reorganization would have been found.⁷⁴ A corresponding interpretation should be made of the "B" reorganization requirements. The "B" reorganization definition contemplates that as little as 80 percent "control," and no more, can be acquired by the acquiring corporation in a "B" reorganization solely for voting stock. If this can be done in a tax-free transaction by the giving of voting stock of Corporation A, even though 20 percent of the stock of Corporation W is not acquired by Corporation A, it makes no sense to destroy the tax-free nature of the exchange

⁷³ 130 F. (2d) 145 at 148. Judge Learned Hand, who dissented on the main point, did not mention this portion of the majority's opinion. The only portion of the government's brief which dealt with this question was a footnote (p. 21) that there was not a tax-free reorganization "because both cash and taxpayer's own shares were used in the acquisition," citing the *Southwest Consolidated Corp.* decision.

Query whether the Second Circuit majority was influenced not only by the treasury stock aspect of the case, but also by the fact that all the additional shares acquired in 1935 were acquired from *one* stockholder, without any written plan of reorganization being adopted. Cf. *William Hewitt*, 19 B.T.A. 771 (1930), note 81 *infra*.

⁷⁴ *Roosevelt Hotel Co.*, 13 T.C. 399 at 408 (1948) (reviewed) acq. 1950-1 Cum. Bul. 4; *Southland Ice Co.*, 5 T.C. 842 at 850 (1945) (reviewed) acq. 1946-1 Cum. Bul. 4.

by penalizing the parties to the qualifying exchange because in the same transaction, or in a prior or contemporaneous transaction, some of the remaining 20 percent is acquired for boot.

For example, Corporation *A* might desire to acquire all of the common stock (the only class outstanding) of Corporation *W*. It feels that 80 percent or more of the shareholders of Corporation *W* would be willing to exchange their shares in a tax-free exchange for a part of its own voting stock, but that some small minority would not accept an exchange offer, although they would be likely to accept a cash offer resulting in recognized capital gain (or loss) to them.⁷⁵ Assuming the problem of settling the conditions of the cash offer is met so that an undue number of shareholders are not encouraged to request cash, and yet the terms are such that all, or almost all, of the stock is gotten in hand, why should the otherwise qualifying tax-free reorganization be penalized because some shareholders choose to take cash for their shares? It is submitted that such a transaction is probably permitted under section 368(a)(1)(B) of the 1954 code. To hold otherwise would be to treat the 1954 code as a patchwork quilt with no organized pattern.

I think we are justified in assuming that the basic congressional aims with respect to "B" and "C" reorganizations are the same—if Corporation *A* acquires substantially all of the properties (or 80 percent under the 80 percent-20 percent rule⁷⁶) of Corporation *W*, or stock representing 80 percent "control" of Corporation *W*, in exchange solely for all or a part of its voting stock, then Corporation *W* or its shareholders are considered to have retained a sufficient continuity of interest in the business enterprise conducted by Corporation *W* to warrant the application of the tax-free reorganization rules. It is doubtful that Congress intended that if in a single transaction Corporation *A* acquires 80 percent of Corporation *W*'s common stock (the only class outstanding) and in the same or a contemporaneous transaction acquires the

⁷⁵ Cf. *Daisy M. Ward*, 29 B.T.A. 1251 (1934) (reviewed) non-acq. XIII-1 Cum. Bul. 31 (1934), petition for review dismissed (8th Cir. 1935) 79 F. (2d) 381, where a repurchase by Corporation *A* of its stock, upon demand of Corporation *W* shareholders, pursuant to an agreement giving them an option to sell, was held to be a separate transaction; *The Fifth Avenue Bank of New York*, 31 B.T.A. 945 at 950 (1934), *affd.* (3d Cir. 1936) 84 F. (2d) 787.

The problems involved when dealing with minority shareholders who want cash are discussed (with particular reference to the 1928 Act) in MILLER, HENDRICKS AND EVERETT, *REORGANIZATIONS AND OTHER EXCHANGES IN FEDERAL INCOME TAXATION* 112-114 (1931).

⁷⁶ See Part III(A) *infra*.

remaining 20 percent for cash, this will disqualify the reorganization from tax-free status. I suppose the Treasury could contend that where a particular shareholder of Corporation *W* exchanges some of his stock for voting stock and some for cash, this should be treated as an exchange of Corporation *W* stock, considered as a unit, for voting stock plus cash, thus violating the solely for voting stock requirement.⁷⁷ But the terms of the exchange can be made such that the stock given up cannot readily be so unitized.⁷⁸ Moreover, as a practical matter, it is not likely that a shareholder who elects to take voting stock will also elect to take some boot which could be taxable as ordinary income.⁷⁹

But even apart from these reasons, there is an even more obvious reason for regarding the Proposed Regulations as ill-conceived. Under the "creeping control" amendment 20 percent, or indeed any larger or smaller percentage, of Corporation *W*'s stock can be acquired for cash or other boot, and if a subsequent exchange yielding 80 percent "control" is made solely for voting stock of Corporation *A*, the latter exchange constitutes a "B" reorganization. Surely, the fact that a part of Corporation *W*'s stock is acquired for boot contemporaneously with or in the same transaction as that in which 80 percent or more of its stock is acquired solely for voting stock of Corporation *A*, should not disqualify the "B" reorganization, when giving equivalent boot in either an earlier or a later separate transaction would not prevent the exchange from being tax-free. If these transactions are not to be accorded similar treatment under the 1954 code, then legislative action would seem indicated to state clearly an 80-20 percent rule applicable to "B" reorganization in the same manner that such a rule now governs "C" reorganizations.⁸⁰ They day should come when the Internal Revenue Code is a well-ordered universe.

⁷⁷ Cf. Treusch, "Corporate Distributions and Adjustments: Recent Case Reminders of Some Old Problems Under the New Code," 32 TAXES 1023 at 1030, n. 93 and text to n. 104 (1954). The extreme of this view is that a reorganization would not qualify as tax-free where a corporation purchases a single share of stock of another corporation for cash and simultaneously acquires all the remaining shares of stock of such corporation in exchange for a part of its voting stock.

⁷⁸ Cf. Harlow W. Davock, 20 T.C. 1075 (1953); *Owen v. United States*, (D.C. Neb. 1951) 99 F. Supp. 855.

⁷⁹ See I.R.C. (1954), §356(a)(2).

⁸⁰ Cf. the history of the Revenue Act of 1921. Originally the Senate Finance Committee proposed that an acquisition of stock should include substantially all the stock, just as an acquisition of property under that act required that substantially all the properties be acquired. On the Senate floor, an amendment was made to require merely the acquisition of a majority of the voting stock and a majority of the total number of shares of all

Where the stock acquired for cash is purchased from shareholders of Corporation *W* who do not exchange other stock of Corporation *W* for voting stock of Corporation *A*, the issue is clear-cut, for the "unitization" argument is not available to the Treasury. If the exchange offer which constitutes the plan of reorganization only invites an exchange of stock of Corporation *W* for voting stock of Corporation *A*, and apart from the plan the latter purchases some stock of Corporation *W* for cash, it would appear that this would constitute a transaction separate from the reorganization⁸¹ even though consummated during the period of the exchange offer. It is inconceivable that this cash purchase should destroy the tax-free character of the exchanges made under the reorganization plan, whereunder in an unrelated "single transaction"⁸² Corporation *A* acquires "control" of Corporation *W* solely in exchange for a part of Corporation *A*'s voting stock.

Interestingly enough, in the really close case, the Service has used a fiction to help bring a reorganization within the "B" reorganization definition. Recently Standard Oil Company, which had acquired 72.32 percent of the outstanding common stock (the only class outstanding) of Humble Oil & Refining Company in prior years, offered to the minority shareholders of Humble the opportunity to exchange ten shares of Humble common stock for nine shares of voting stock of Standard. The offer was conditional upon Humble shareholders tendering sufficient shares for exchange by November 30, 1954 to give Standard 80 percent control of Humble.⁸³ No fractional shares were

other classes of stock of the acquired corporation. The Senate floor discussion indicates conflicting views as to the purpose of the amendment. See BAAR AND MORRIS, *HIDDEN TAXES IN CORPORATE REORGANIZATIONS* 56-57 (1935); 61 CONG. REC. 6561-6567 (Oct. 21, 1921); Conference Committee Report on Revenue Bill of 1921, H. Rep. 486, 67th Cong., 1st sess., at 17-18, 1939-1 Cum. Bul. (Part 2) 206, 209 (Amendment 47); G.C.M. 8565, IX-2 Cum. Bul. 127 (1930).

⁸¹ Cf. William Hewitt, 19 B.T.A. 771 (1930) (reviewed), appeal dismissed (8th Cir. 1935) 76 F. (2d) 1011. Pursuant to a plan of reorganization Corporation *A* offered to exchange \$40 in cash, one-half a share of its preferred stock and one share of its common stock for each share of common stock tendered by Corporation *W*'s shareholders. Hewitt did not accept the exchange offer, but negotiated a more advantageous exchange with Corporation *A*. This individual deal was held not to be part of the plan of reorganization which otherwise qualified under the 1926 Act.

⁸² The meaning of this phrase is discussed in House Report, pp. A132-A133.

⁸³ The purpose of the exchange was to enable Standard to take advantage of the new "control" rule of I.R.C. (1954), §1504(a), which reduces from 95% to 80% the percentage ownership of an affiliated corporation required in connection with the filing of a consolidated return.

issued, but in lieu thereof any shareholder who deposited a number of shares not divisible by ten was given the option either to sell his interest in less than one share of Standard or to purchase an interest sufficient to entitle him to one additional full share of Standard.⁸⁴ Standard engaged and paid an agent to perform "the necessary ministerial functions attendant to effectuating the exchange of Standard stock for Humble stock, including the sale or purchase of fractional interests."

Before consummating the exchange, Standard obtained a Treasury ruling⁸⁵ that the handling of the fractional shares did not prevent the transaction from qualifying as a "B" reorganization under the 1954 code.⁸⁶ The ruling states, "It will be considered that the stockholders actually received any fractional shares to which they were entitled. Upon the sale of any fractional share by the exchange agent for the account of a particular stockholder, such stockholder will realize gain or loss measured by the difference between the amount received for such fractional share and the cost or other basis of his stock of Humble properly allocable to the fractional share of Standard stock sold"

Note that the agent, paid *in cash* by and acting for Standard, is apparently treated as the agent of the Humble shareholders for the purpose of receiving fractional (and other) shares of Standard and selling the fractional shares for cash.⁸⁷ One explanation for the favorable Treasury attitude is that Standard gave up *solely* a part of its voting stock, and the statute is framed in terms of what the acquiring corporation gives up, rather than what the shareholders of the acquired corporation actually take down. This ignores the fact that the agent was paid in cash and if it acted on behalf of the shareholders, then some cash was paid by Standard to the benefit of the shareholders; if the agent acted solely on behalf of Standard then in effect Standard sold the fractional shares and paid a small amount of cash to some of Humble's shareholders. Either explanation of the agent's role presents difficulties. The very fact that the Treasury will accommodate itself to the device employed in the Standard-Humble

⁸⁴ Cf. the approved issuance of scrip certificates for fractional shares in Rev. Rul. 55-59, Int. Rev. Bul. 1955-6, 7, dealing with a "C" reorganization.

⁸⁵ Letter Ruling dated October 28, 1954, bearing symbols "T:R:R GP."

⁸⁶ Neither did the fact that Standard paid the agent and the agent's expenses in connection with the exchange, and paid all state and federal issuance and transfer taxes.

⁸⁷ Cf. Daisy M. Ward, 29 B.T.A. 1251 (1934), note 75 *supra*; The Fifth Avenue Bank of New York, 31 B.T.A. 945 (1934), note 75 *supra*; Rev. Rul. 54-65, 1954-1 Cum. Bul. 101.

reorganization indicates the desirability of not construing the "B" reorganization definition narrowly. Under section 368(a)(1)(B), properly interpreted, the artificial nature of the procedure would not have been necessary had Standard been certain that it would obtain enough shares of Humble for whole shares of Standard to give it 80 percent control of Humble—in such case it could have itself given cash for fractional shares without the intervention of an agent.

III. BUYING OUT MINORITY INTERESTS FOR CASH

When it was desired, under the 1939 code, to buy out a small minority interest for cash upon the merging of two corporations, a statutory merger (an "A" reorganization) rather than a "practical merger" (a "C" reorganization) offered the solution to the problem. The trouble was that it was (and still is) not always possible to effect a statutory merger; not all states have merger statutes.⁸⁸

The striking feature of the "A" reorganization provision under both the 1939 and 1954 codes⁸⁹ is that there is no spelling out of what the shareholders of the merged or of the continuing corporation must receive. Thus, it is possible for any combination of voting and non-voting stock, securities, cash and other property to be received by them without disqualifying the reorganization from meeting the "A" reorganization requirements.⁹⁰

The 1954 code narrows considerably the differences in tax treatment of "A" and "C" reorganizations. An important change designed to make practical mergers more feasible from a tax viewpoint is one providing⁹¹ that (1) if a corporation acquires substantially all of the properties of another corporation, and (2) if the "C" reorganization definition would be met but for the fact the acquiring corporation exchanges "money or other property" in addition to voting stock, and

⁸⁸ For a compilation of states not permitting statutory mergers or consolidations of a "domestic" and a "foreign" corporation, or even of two domestic corporations, see Fahey "Income Tax Definition of Reorganization," 39 COL. L. REV. 933 at 948 (1939). Mr. Fahey also discusses at pp. 946-947 the application of the "A" reorganization definition to mergers and consolidation under federal statutes. See also Gutkin, "Merger and Consolidation Problems," N.Y.U. 8TH ANNUAL INSTITUTE ON FEDERAL TAXATION 174 at 175 (1950). Some state statutes have been amended since the lists were compiled.

⁸⁹ I.R.C. (1939), §112(g)(1)(A); I.R.C. (1954), §368(a)(1)(A).

⁹⁰ However, the judicially developed concepts of "continuity of interests" and of "business purpose" must be met, and the taxation of "boot" provisions must be taken into account.

⁹¹ I.R.C. (1954), §368(a)(1)(B). See Senate Report, pp. 263, 274. Cf. House Bill §359(c), and the discussion in H. Rep., pp. A133-A134.

(3) if the acquiring corporation acquires solely for its own voting stock or solely for voting stock of a corporation controlling it, property of the transferor corporation having a fair market value which is at least 80 percent of the fair market value of *all* (not merely the transferred portion) of the transferor corporation's property, then such acquisition will be treated⁹² as a "C" reorganization. Solely for the purpose of this determination, "the amount of any liability assumed by the acquiring corporation and the amount of any liability to which any property acquired is subject,"⁹³ is treated as money paid for the property.

Thus, under the 1954 code, as long as voting stock is given for property having a fair market value which is at least 80 percent of the fair market value of all of the property of the transferor corporation, the remaining consideration paid by the acquiring corporation can be money or other property. Moreover, there is no requirement that the consideration other than voting stock be distributed pro rata to the stockholders of the transferor corporation.⁹⁴ Even if a corporation's entire assets are transferred in a "C" reorganization for voting stock plus cash not exceeding the 20 percent restriction, the "continuity of interest" rule will not be violated if one group of shareholders receives only voting stock and the other group of shareholders receives only cash.⁹⁵ All this is in furtherance of the congressional intent to alleviate the difficulties in completing transactions which existed under the 1939 code where certain shareholders of the transferor corporation wished to receive property rather than stock in the acquiring corporation.

⁹² Subject to the provisions of I.R.C. (1954), §368(a)(2)(A), which provides that if a transaction meets both the "C" and the "D" reorganization definitions it is treated as a "D" reorganization.

⁹³ It would seem, since a liability which is assumed may also be a liability to which an acquired property is subject, that modification of this language would be in order when the "Technical Changes Act of 1955" is under consideration.

⁹⁴ If the transferor corporation does not distribute the money or other property received (other than stock or securities of the acquiring corporation) in pursuance of the plan of reorganization, gain will be recognized, but not in excess of the money and fair market value of other property received and not distributed. I.R.C. (1954), §361(b)(1)(B).

Shareholders of the transferor corporation who wish to receive securities, money or other property in addition to voting stock, should be aware of the possibility of realization of some ordinary income under I.R.C. (1954), §356(a)(2). See I.R.C. (1954), §§354(a)(2), 356(a)(1)(B) and 356(d)(2)(B). Cf. I.R.C. (1954), §302(b).

⁹⁵ Implicit in the adoption of this rule is that paying out 20% of the shareholders in cash does not run afoul of the "continuity of interest" rule. See Senate Report, p. 52. See also Lyons, "Realignment of Stockholders' Interests in Reorganizations Under Section 112(g)(1)(D)," 9 TAX L. REV. 237 (1954).

A. *The 80 Percent-20 Percent Rule*

The application of the 80 percent-20 percent rule may be illustrated⁹⁶ as follows: Corporation A has assets worth \$100,000 and \$10,000 in liabilities. Corporation Y acquires \$98,000 worth of assets subject to a liability of \$10,000. In exchange for these assets, Corporation Y transfers its own voting stock, assumes the \$10,000 liability, and pays \$8,000 in cash. This transaction qualifies as a "C" reorganization even though a part of the assets of Corporation A is acquired for cash. If, however, the assets of Corporation A in the above example were subject to \$50,000 in liabilities rather than only \$10,000, an acquisition of all the assets subject to the liabilities could only be for voting stock because Corporation A's liabilities alone are in excess of 20 percent of the fair market value of all of the property transferred. In such a case, a statutory merger or consolidation would be required in order to have the transaction qualify as a reorganization.⁹⁷

Although the transferor corporation can transfer up to 20 percent (in fair market value) of its property for other than voting stock, in practice this provision will not have wide application. The reason for this is the revival to a limited extent of the rule derived from the *Hendler*⁹⁸ case, which would treat the assumption by a transferee corporation of the liabilities of a transferor as the receipt of "boot" by the latter. This "melancholy victory"⁹⁹ by the government was reversed by the enactment of section 213 of the Revenue Act of 1939, the provisions of which are continued in the 1954 code.¹⁰⁰ Nevertheless, since the transfer of substantially all of the properties of one corporation to another in a "C" reorganization situation is commonly accompanied by the latter assuming the indebtedness of the transferor, any hoped-for benefit from the liberalization of the "C" reorganization rules by section 368(a)(2)(B) may prove to be illusory in many instances.

⁹⁶ The illustration is taken from Senate Report, pp. 274-275. See also Proposed Regulations, §1.368-2(d)(3).

⁹⁷ If there were some special reasons for not transferring certain assets to the acquiring corporation, these assets could be distributed to the stockholders of the transferor corporation as part of the plan of reorganization, the state law as to mergers and consolidations permitting.

⁹⁸ *United States v. Hendler*, 303 U.S. 564, 58 S.Ct. 655 (1938), rehearing den. 304 U.S. 588, 58 S.Ct. 940 (1938). The ramifications of the *Hendler* decision are discussed in Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 *YALE L.J.* 1 (1940).

⁹⁹ See PAUL, *STUDIES IN FEDERAL TAXATION*, Third Series, 138 (1940); Surrey, "Assumption of Indebtedness in Tax-Free Exchanges," 50 *YALE L.J.* 1 at 10-14 (1940), which recite the difficulties the Treasury was faced with after the government won the *Hendler* case.

¹⁰⁰ See I.R.C. (1954), §§357 and 368(a)(1)(C).

The assumption of all liabilities of the transferor, including contingent or undisclosed liabilities, could cause a violation of the terms of 80 percent-20 percent exception which would not show up until some time after the consummation of the reorganization. The exception in section 368 (a)(2)(B) is not written in terms of the estimated amount of liabilities assumed, but rather in terms of "the amount," which could perhaps be determined by hindsight. The discreet will therefore, in such circumstances, choose the statutory merger or consolidation route to accomplish their purposes and not risk the uncertainty of a practical merger qualifying as a tax-free "reorganization." The limited assumption of liabilities could also be considered.

The Proposed Regulations show no awareness of the need to define what is meant by "the amount" of liabilities assumed. It is arguable that where all the liabilities of the transferor are assumed by the transferee, including contingent and undisclosed liabilities, "the amount" of the liabilities for the purpose of applying the 80 percent-20 percent rule should be the *estimated* amount value thereof based on the facts known to the parties on the date of the transfer, rather than the *actual* ultimate amount of liability.¹⁰¹ Otherwise, in some instances it may be years after a transaction takes places before one could be certain that the terms of the 80 percent-20 percent exception have been met.

There are certain practical difficulties attendant upon the above suggestion. For one thing, parties to a corporate reorganization would always run the tax risk, in valuing contingent and disputed liabilities, that the Service would later¹⁰² disagree with the valuation. The Service is especially likely to raise the issue if subsequent events should be such that the estimated valuation in fact proves to have been too low. The parties should not be required to run this tax risk where they can show that the valuation of contingent and disputed liabilities was arrived at in good faith and as a result of arm's-length negotiations seeking to fix their relative interests.

How should a liability be valued if its actual or potential existence is undisclosed (innocently or otherwise) by the transferor to the transferee? In such a case there can be no value estimated by the transferee,

¹⁰¹Cf. dissenting opinion of Justice Reed in *Commissioner v. Estate of Louis Sternberger*, 348 U.S. 187 at 200, 75 S.Ct. 229 (1955). Interpreting I.R.C. (1939), §812, which allows as a deduction "the amount of all bequests . . . to . . . any corporation organized and operated exclusively for . . . charitable . . . purposes . . .," Justice Reed states at 201: "It is the 'amount' of the bequest that is deductible—its presently ascertainable value."

¹⁰²It is doubtful that the Service would give an advance ruling on the valuation question. See Int. Rev. - Mimeograph No. 100, Com. No. 11, January 12, 1953, paragraph 4,

to whom the actual or potential liability has no known existence. Also, neither party may be aware of the existence of a potential liability. For example, if the transferee assumes all liabilities, and thereafter the Service asserts the existence of a completely unexpected tax liability on the part of the transferor on a theory which everyone had theretofore assumed was clearly settled in favor of the taxpayer,¹⁰³ whose judgment as to "the amount" (as of the reorganization date) of the tax liability assumed by the transferee is to be accepted—the taxpayer's or the Service's (based on the Service's internal administrative thinking on the problem)? Here again, a party acting in good faith and at arm's length should be permitted to rely on the estimated value of assumed contingent and other liabilities.

In view of the above difficulties, it is likely that the 80 percent-20 percent rule will in practice be little availed of, except in those cases where the transferee does not assume contingent and undisclosed liabilities. Perhaps in the future the Congress may see fit to exempt such liabilities (or indeed, all assumed liabilities)¹⁰⁴ from the 80 percent-20 percent formula provided in section 368(a)(2)(B)(ii).

IV. RECEIPT OF VOTING STOCK OF BOTH ACQUIRING CORPORATION AND ITS PARENT OR SUBSIDIARY IN "C" REORGANIZATION

The new "C" reorganization definition does not specifically permit the corporation transferring substantially all of its assets (Corporation W), or its shareholders, to receive both voting stock of the acquiring corporation (Corporation A) and voting stock of its parent (Corporation P); the acquisition by one corporation of substantially all of the properties of another corporation must be in exchange "solely for all or a part of its [the acquiring corporation's] voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation). . . ."

It is questionable whether any valid "continuity of interest" policy decision underlies this particular legislative restriction. If Congress has chosen to decree that the transferor corporation (Corporation W)

¹⁰³ For example, the Godley-Hirshon problem. See Mintz and Plumb, "Dividends in Kind—The Thunderbolts and the New Look," 10 TAX L. REV. 41 (1954); Michael P. Erburu, 23 T.C. No. 104, January 31, 1955.

¹⁰⁴ Cf. I.R.C. (1954), §368(a)(1)(C): ". . . in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded. . . ."

or its shareholders have a sufficient continuity of interest in the assets transferred to Corporation A where the consideration for the transfer is voting stock in Corporation P, it defies logic for it to deny that there is a sufficient continuity of interest where Corporation W or its shareholders receive not only some voting stock in Corporation P but also voting stock in Corporation A.¹⁰⁵ Indeed, the necessary continuity of interest was found to exist in such a situation by both the Board of Tax Appeals and the Court of Appeals for the Third Circuit,¹⁰⁶ prior to the Supreme Court's decision in the *Groman* case. The restriction is even more perplexing since the possibility exists under the new "C" reorganization provision of Corporation W transferring its assets to Corporation A in exchange for voting stock of Corporation P, and of Corporation A immediately transferring the assets to a subsidiary of Corporation A.¹⁰⁷ The assets of Corporation W in such a case are twice removed from Corporation P, and yet the Corporation W shareholders, through ownership of a part of Corporation P's voting stock, are deemed to have a sufficient continuity of interest in the transferred assets to constitute the transaction as a "C" reorganization.

Regardless of the failure of section 368(a)(1)(C) specifically to permit Corporation W or its shareholders to receive both voting stock of Corporation P and voting stock of Corporation A, the 80 percent-20 percent rule does appear to permit in a limited way the giving of both Corporation P voting stock and Corporation A voting stock. The Proposed Regulations do not take this possibility into account, and the following sentence in section 1.368-2(d) of the Proposed Regulations requires modification: ". . . if the properties of Corporation W are acquired in exchange for voting stock of both Corporation P and Corporation A, the transaction will not constitute a reorganization under Section 368(a)(1)(C)."

¹⁰⁵ Perhaps what Congress was concerned with here, if it thought of the problem at all, was the possibility of a "bail-out" should the Corporation W shareholders receive voting stock of both Corporation P and Corporation A. Cf. I.R.C. (1954), §306.

¹⁰⁶ *Commissioner v. Fifth Avenue Bank of New York*, (3d Cir. 1936), 84 F. (2d) 787, affg. 31 B.T.A. 945 (1934), interpreting the Revenue Act of 1928. Antitoxin transferred all of its assets to Laboratories (a newly-formed subsidiary of Cyanamid) under a reorganization agreement drawn up between Antitoxin and Cyanamid, in exchange for 64,500 shares of Cyanamid Class B common and 75,000 shares of Laboratories nonvoting preferred. Both Cyanamid and Laboratories were held to be parties to the reorganization. The Third Circuit said: "Undoubtedly, there is the continuity of interest in the Antitoxin assets through acquisition of the stock in both companies which is stressed in *Helvering v. Minnesota Tea Company*. . . ." 84 F. (2d) 787 at 789.

¹⁰⁷ I.R.C. (1954), §368(a)(1)(C) and (2)(C).

One of the conditions of the 80 percent-20 percent rule is that it applies only if "the acquisition would qualify under paragraph (1)(C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock. . . ." Suppose all of the assets of Corporation *W* are acquired and 80 percent of the consideration therefor is voting stock of Corporation *A* and 20 percent is voting stock of Corporation *P* (Corporation *A* being the acquiring corporation), or suppose it is the other way around and it is 80 percent Corporation *P* and 20 percent Corporation *A* voting stock (Corporation *P* being the acquiring corporation, with an immediate transfer of Corporation *W*'s assets to Corporation *A*'s). It would appear that the voting stock in the 20 percent category may properly be treated as "other property" within the meaning of the above-quoted qualification. There is nothing in the statute¹⁰⁸ which requires that the "money or other property" referred to in section 368(a)(2)(B)(ii) constitute "boot," the receipt of which is subject to the recognition of gain rules of section 356, or which indicates that voting stock (or nonvoting stock) of a party to the reorganization was not meant to be included in the scope of "other property."

It may be that ultimately the Treasury will recognize, either voluntarily or through judicial mandate, that there is a "C" reorganization and that the 80 percent-20 percent rule applies where all of the assets of Corporation *W* are acquired and 80 percent of the consideration therefor is voting stock of Corporation *A* and 20 percent of the voting stock of Corporation *P* (Corporation *A* being the acquiring corporation), or where 80 percent is voting stock of Corporation *P* and 20 percent is voting stock of Corporation *A* (Corporation *P* being the acquiring corporation, with an immediate transfer of Corporation *W*'s assets to Corporation *A*). The Treasury, nevertheless, may couple such recognition with a contention that the *Groman* decision is still good law, and that at least in the case where the 20 percent is voting stock of Corporation *P* (Corporation *A* being the acquiring corporation), Corporation *P* is not a party to the reorganization.¹⁰⁹ Under this approach the voting stock of Corporation *P* would constitute "boot" received as part of a "C" reorganization. However, where Corporation *P* is the acquiring corporation, with an immediate transfer of Corporation *W*'s assets to Corporation *A*, I believe there is substance to the petition that Corporation *A* as well as Corporation *P* is a party to the

¹⁰⁸ See also Senate Report, p. 52; House Report, p. A133.

¹⁰⁹ But cf. note 106 *supra*, and the text thereto. See note 36 *supra*.

"C" reorganization, and that no "boot" is involved in the transaction. Indeed, the *Bashford* case¹¹⁰ assumes this conclusion as to Corporation A, and the 1954 code¹¹¹ brings about this result as to Corporation P.

CONCLUSION

It seems appropriate to conclude by quoting Justice Reed's recent pronouncement¹¹² on the Regulations problem:

"Regulations do not have the safeguards of federal statutory enactments. Interested parties outside the Internal Revenue Service perhaps may not be heard. Reports explaining the action are not available. Public discussion, such as happens in Congress, does not take place. In short, we think that reenactment of a statute after the due adoption of a regulation does not make the regulation a part of the statute. It is only an indication of congressional purpose to be weighed in the context and circumstances of the statutory language."

When the Proposed Regulations under subchapter C of chapter 1 of the 1954 code, which includes the corporate reorganization provisions, were published in the *Federal Register* on December 11, 1954, the Treasury announced that prior to the adoption of the final Regulations, consideration will be given to "any data, views, or arguments pertaining thereto" which were submitted in writing (in duplicate) by January 10, 1955 to the Commissioner of Internal Revenue. This 30-day deadline was later extended to January 24, 1955. It is to be hoped that the Treasury will carefully consider the suggestions made to it, bearing constantly in mind that its proper function is to interpret and administer within the framework of the statutory language and congressional intent.¹¹³ One of the deans of the tax bar has observed,

¹¹⁰ In *Commissioner v. Bashford*, (3d Cir. 1937) 87 F. (2d) 827, revd. sub nom. *Helvering v. Bashford*, 302 U.S. 454, 58 S.Ct. 307 (1938), the Commissioner conceded that Corporation A was a party to the reorganization; the issue was whether Corporation P was also a party thereto.

¹¹¹ Section 368(b), last sentence.

¹¹² *Commissioner v. Estate of Louis Sternberger*, 348 U.S. 187 at 206, 75 S.Ct. 229 (1955) (dissenting opinion).

¹¹³ While the words of Congress often are sufficient in and of themselves to determine the purpose of legislation, and the plain meaning of the words will be followed, where the meaning would lead to absurd or futile results, or even merely an unreasonable one "plainly at variance with the policy of the legislation as a whole," the Supreme Court has followed that policy rather than the literal words. *United States v. American Trucking Association, Inc.*, 310 U.S. 534 at 543, 60 S.Ct. 1059 (1940); *Markham v. Cabell*, 326 U.S. 404 at 409, 66 S.Ct. 193 (1945).

"The government cannot be expected to abandon its past tendency to press the courts as far as possible to interpret and develop the tax law in its favor."¹¹⁴ Nevertheless, the exercise of a measure of self-imposed Treasury restraint when promulgating the final Regulations would be a wholesome development. Experience indicates that over-zealousness in taking the narrow view does not always serve the Treasury well, and that the reasonable approach better serves the common weal.¹¹⁵

¹¹⁴ Darrell, "The Internal Revenue Code of 1954," 1955 SOUTHERN CALIFORNIA TAX INSTITUTE 1 (1955). It is equally true, as Mr. Darrell observes, that "Taxpayers cannot be expected to cease their never ending search for means of cutting down their taxes."

¹¹⁵ See, for example, the article and treatise cited in note 99 *supra*, discussing the Treasury's difficulties with the problem of assumption of indebtedness in corporate reorganizations.