Taxation - Federal Income Tax - Exchange of Debentures for Preferred Stock as Tax-Free Reorganization

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TAXATION—FEDERAL INCOME TAX—EXCHANGE OF DEBENTURES FOR PREFERRED STOCK AS TAX-FREE REORGANIZATION—Plaintiff held common and preferred stock of the Gulf States Paper Corporation. In 1942 plaintiff received new debentures in exchange for his preferred stock, pursuant to a plan for the recapitalization of the company whereby the entire 25,000 shares of previously outstanding preferred stock (including plaintiff's 208 shares) were exchanged for new debentures of like value. In 1950 the Commissioner assessed an income tax deficiency against plaintiff, determining that the redemption and cancellation of the preferred stock represented a distribution essentially equivalent to the distribution of a dividend and taxable under section 115(g)(1) of the Internal Revenue Code. Plaintiff sued for refund of the amounts paid on the deficiency assessment and was awarded judgment by the district court. On appeal, held, affirmed. The corporation's exchange of debentures for preferred stock accomplished a reshuffling of the capital stock structure which constituted a "recapitalization" and hence a tax-free "reorganization" within the meaning of section 112(b)(3) of the Internal Revenue Code. Davis v. Penfield, (5th Cir. 1953) 205 F. (2d) 798.

As indicated by the congressional reports, the purpose of statutory non-recognition of gain or loss from corporate reorganization transactions is to encourage legitimate reorganizations required to strengthen the financial condition of a corporation, and to prevent losses from being incurred by shareholders who receive new securities without substantially changing their original investment. Misuse of the reorganization non-recognition provisions as vehicles "for conveying earnings from accumulations to the stockholders" gave rise to judicial doctrines of construction which are intended to prevent frustration of legislative purpose in cases of literal compliance with statutory requirements. With respect to consolidations or mergers, the tax exemption is restricted by requiring

1 I.R.C., §115(g)(1): "... Redemption of stock. In general. If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."


3 I.R.C., §112(g)(1)(E): "... Definition of reorganization. As used in this section (other than subsection (b)(10) and subsection (1)) and in section 113 (other than subsection (a)(22))—The term 'reorganization' means ... a recapitalization."

4 Ibid.

5 I.R.C., §112(b)(3): "Recognition of gain or loss—... Exchanges solely in kind—... Stock for stock on reorganization. No gain or loss shall be recognized 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."


7 Note 5 supra.


continuation of some proprietary interest on the part of persons who were owners of the enterprise prior to the reorganization. Parallel to the continuity of interest doctrine is the requirement declared by the United States Supreme Court in *Gregory v. Helvering* that a plan of reorganization must have a legitimate business purpose independent of tax-saving motives. The business purpose doctrine serves to distinguish genuine reorganizations from sham transactions, and is also applied to determine whether the assumption of liabilities is part of a tax-free exchange or boot. This test not only the bona fides of a transaction but also the means employed to accomplish the end result. The Supreme Court further qualified the non-recognition provisions by holding in *Bazley v. Commissioner* that section 115(g)(1) of the Internal Revenue Code cuts across and undermines the effect of a recapitalization which, although meeting the technical requirements of section 112(b)(3), results in a distribution that is essentially equivalent to the distribution of a taxable dividend. Section 115(g)(1) was enacted primarily to prevent the avoidance of tax on the distribution of corporate earnings by means of the redemption of stock dividends. However, its application to corporate reorganizations has given rise to a "net effect" doctrine which requires in each case a factual determination of the question whether a distribution is made at such a time and in such a manner that it can be regarded as the equivalent of the distribution of a taxable dividend. It was this question that was raised in the principal case in the context of a corporate recapitalization by which the entire issue of outstanding preferred

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10 Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 53 S.Ct. 257 (1933); followed in LeTulle v. Scofield, 308 U.S. 415, 60 S.Ct. 313 (1940). See Treas. Reg. 118, §39.112(g)-1. To the effect that the continuity of interest doctrine is not directly pertinent to a recapitalization such as that in the principal case, see Clarence J. Schoo, 47 B.T.A. 459 (1949); and Griswold, "'Securities' and 'Continuity of Interest,'" 58 Harv. L. Rev. 705 at 716 (1945).


12 If bonds are exchanged for stock for the sole purpose of benefiting by interest deductions, the deductions can probably be taken under §23(b) of the Code, despite the purpose of the exchange. The Toledo Blade Company, 11 T.C. 1079 (1948), affd. (6th Cir. 1950) 180 F. (2d) 357, cert. den. 340 U.S. 811, 71 S.Ct. 38 (1950). While interest deduction is a genuine and legitimate purpose of a business, it is probably not an objective which Congress would intend to encourage. See Bazley v. Commissioner, note 8 supra.

13 See Heady v. Commissioner, (7th Cir. 1947) 162 F. (2d) 699.


16 Note 8 supra.


18 Whether a corporation has cancelled its stock at such time and in such manner as to make the distribution and cancellation essentially equivalent to the distribution of a taxable dividend is a question of fact. Brown v. Commissioner, (3d Cir. 1935) 79 F. (2d) 73; Hirsch v. Commissioner, (9th Cir. 1941) 124 F. (2d) 24.

19 The Internal Revenue Code furnishes no definition of "recapitalization." A broad rather than restricted meaning was ascribed to the term in Commissioner v. Neustadt's
stock was exchanged for new debentures. The Tax Court first rejected the Commissioner's contention that such an exchange fell within the terms of section 115(g)(1) in Annis Furs, Inc. 20 Except for the impetus of the Bazley case, this would very likely have been decisive; but the fact that the bonds given in that case were received in addition to existing rights, rather than in substitution of such rights as in the principal case, has been too readily overlooked. 21 Where bonds are exchanged directly for preferred stock and constitute the sole consideration therefor, and where the distribution of bonds is highly disproportionate to holdings in common stock, it would seem there is little probability that the distribution is a disguised dividend. 22 The net effect of such a recapitalization in the principal case was not to better the existing tax position of stockholders, but to simplify capital structure 23 and to eliminate the potential five percent redemption premium attached to the old preferred. The exchange accomplished results which could not have been accomplished by the direct distribution of a debenture dividend. Furthermore, application of a theory of dividend equivalence to an exchange of debentures for preferred stock would permit confiscation of the basis of the preferred stock surrendered. The Commissioner's plan to transfer such basis to the unrelated, disproportionate holdings of common would not prevent those who held preferred but no common from losing their preferred investment basis entirely. 24 While in proper factual circumstances it may be appropriate to regard section 115(g)(1) as controlling the tax consequences of a literal reorganization, it seems clear that a direct exchange of debentures for preferred stock, such as executed in the principal case, falls outside the scope of the Bazley decision. This is not to criticize the conclusion of the Bazley case, however, for the non-recognition provisions should be restricted to cases in which the change of rights is not definitive enough to give rise to tax incidence.

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Trust, (2d Cir. 1942) 131 F. (2d) 528. Recapitalization was defined as the "reshuffling of a capital structure, within the framework of an existing corporation," in Helvering v. Southwest Consolidated Corp., 315 U.S. 194 at 202, 62 S.Ct. 546 (1941).


21 It is significant that the Tax Court, in subjecting the transaction in the Bazley case to tax, expressly distinguished the Annis Furs case. Alice H. Bazley, 4 T.C. 897 (1945). Moreover, the Tax Court earlier entered a memo opinion in the case of Mary N. Crofoot, 4 T.C.M. 97 (1945), holding that an exchange of preferred stock for twenty-five year registered notes constituted a non-taxable recapitalization.

22 There was no substantial or controlling identity in the ratios of preferred and common stock in the principal case. See Penfield v. Davis, note 2 supra, at 299.

23 Simplification of capital structure is a valid business purpose. Wolf Envelope Company, 17 T.C. 471 (1951).

24 In Daisy Seide, 18 T.C. 502 (1952), the Commissioner argued for the application of § 115(g)(1) only as to those recipients of debentures who held common shares as well as the preferred shares exchanged. As to those holding only the preferred shares exchanged, the Commissioner argued realization of capital gain.