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TAXATION-INCOME TAX-EXEMPT REORGANIZATIONS-RECAPITALIZATION AS DEVICE FOR DISTRIBUTING EARNINGS

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TAXATION—INCOME TAX—EXEMPT REORGANIZATIONS—RECAPITALIZATION AS DEVICE FOR DISTRIBUTING EARNINGS—Petitioner owned more than three-fourths of the stock in a corporation whose shares had a par value of $100. Except for one share, his wife owned the remainder. Under a plan of recapitalization the stockholders received in exchange for each old share, five shares of no par stock with a stated value of $60 per share plus a portion of $400,000 worth of callable debentures issued by the corporation. At the time of this exchange the earned surplus of the corporation exceeded $850,000. The commissioner held that the full value of the debentures received was chargeable to the taxpayer as income. The Tax Court agreed, although the corporation had complied with the literal terms of the statute, something more, a legitimate corporate purpose, was needed before the transaction could qualify as a tax exempt reorganization.[1] The circuit court of appeals affirmed the

[1] "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." 26 U.S.C. (1940) § 112 (b) (3).

"The term reorganization means: . . . . (E) a recapitalization. . . ." Id., § 112 (g) (1).

decision and the Supreme Court granted certiorari. *Held*, affirmed, two justices dissenting. The reorganization was not one which obtained the privileges afforded by section 112 (g). *Bazley v. Commissioner of Internal Revenue*, (U.S. 1947) 67 S. Ct. 1489.[2]

Frequently, tax payers, by literally complying with the provisions of section 112 (g), have demonstrated its vulnerability to tax avoidance schemes. The courts, however, have prevented the frustration of the section by judicial legislation. For example, prior to 1934 the statutory definition of one type of reorganization required a transfer by a corporation of a majority of its stock or of substantially all of its assets, but made no provision as to the consideration which was to be received from the transferee.[3] The courts supplemented the statute by implying the condition, that the consideration represent a "continuity of interest."[4] Thus notes and bonds were held not to satisfy the requirement.[5] A condition that the consideration must give the transferor a definite and material interest in the purchaser and also represent a substantial value of the assets transferred was also invoked to fortify the section.[6] In *Gregory v. Helvering*[7] the court announced yet another judicial restriction: the reorganization must be for a business or corporate purpose. It would seem that the Court, in the principal case, has extended the doctrine of the *Gregory* case. For there the reorganization was illusory; the corporation, which was created merely to comply with the reorganization requirements, was immediately dissolved after it had served its purpose.[8] Here the reorganization was at least real in the sense

[2] A companion case, Adams v. Commissioner, was disposed of along with the principal case. There, too, the issuance of debenture bonds in a recapitalization was treated as a distribution of the corporation's accumulated earnings. The Court also stated: "The findings by the Tax Court that the reorganization had no purpose other than to achieve the distribution of the earnings is unaffected by the bookkeeping detail of leaving the surplus account unaffected."

[3] Revenue Acts of 1924 and 1926, § 203 (h)(1); Revenue Acts of 1928 and 1932, § 112 (i)(1).

[4] Brookes, "The Continuity of Interest Test in Reorganizations—a Blessing or a Curse," 34 CAL L. REV. 1 (1946); 49 YALE L. J. 1079 (1940); 3 MERTENS, LAW OF FEDERAL INCOME TAXATION, § 20.54 (1942).

[5] Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 53 S. Ct. 257 (1933); Cortland Speciality Co. v. Commissioner, (C.C.A. 2d, 1932) 60 F. (2d) 937, cert. den., 288 U.S. 599, 53 S. Ct. 316 (1933); Le Tulle v. Scofield, 308 U.S. 415, 60 S. Ct. 313 (1940).

[6] Helvering v. Minnesota Tea Co., 296 U.S. 378, 56 S. Ct. 269 (1935).

[7] 293 U.S. 465, 55 St. Ct. 266 (1935). This case was decided under the 1928 Revenue Act. Section 112 (i)(1)(B) defined one form of reorganization as, "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders both are in control of the corporation to which the assets are transferred." The section was complied with in the following manner. A corporation wholly owned by the taxpayer transferred 1000 shares of stock in *B* corporation to a newly created corporation *C*, which then issued all of its shares to the taxpayer. Within a few days the taxpayer dissolved corporation *C* and on liquidation received the 1000 shares of *B* stock. The court held that while the plan conformed to the term of the statute there was no reorganization within the intent of the statute.

[8] In Chisholm v. C.I.R., (C.C.A. 2d, 1935) 79 F. (2d) 14 at 15, Judge Learned

that the corporation has continued to operate in its changed form. But it would seem that the extension is justified, for the only purpose of the reorganization was to conceal the trail of a dividend to the taxpayer. The corporation was in no better position to conduct its affairs after this recapitalization. The net result was that it's earned surplus had been reduced by $400,000 with no resulting benefit. The stockholders benefitted, for without reducing their equity in the corporation, they had received corporate obligations which were of value. They were even callable, which tends to point to a sham transaction and justifies labelling the debentures "dividends," for the taxpayer controlled the corporation and could convert them to cash at any time. As a second ground for its decision, the court stated, in effect, that these callable debentures were not securities within the meaning of section 112 (b) (3).[9] Since the court referred to *Commissioner v. Estate of Bedford*,[10] it is submitted that the debentures would also be taxable as dividends under section 112 (c) (2). Therefore, even though adhering to the rule of the *Dobson* case,[11] and accepting the Tax Court's finding of fact that a recapitalization is for a legitimate corporate purpose, the Supreme Court will still scrutinize the transaction to see if the corporate obligations are securities. It would seem that only obligations which do not too closely resemble cash would be considered securities in a situation such as that presented by the principal case.[12]

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Hand said in referring to the Gregory case: " . . . the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world."

[9] See note 1, supra.

[10] Commissioner of Internal Revenue v. Estate of Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945). In this case a distribution of cash out of earning and profits of a corporation, pursuant to a recapitalization which was a reorganization as defined by section 112 (g) of the Revenue Act of 1936 was held to have had the effect of the distribution of a taxable dividend within the meaning of section 112 (c) (2).

[11] Dobson v. Commissioner of Internal Revenue, 320 U.S. 489, 64 S. Ct. 239 (1943).

[12] In Helvering v. Watts, 296 U.S. 387, 56 S. Ct. 275 (1935), stockholders owning all of the shares of corporation *A* exchanged them for stock in corporation *B* and mortgage bonds of corporation *A* guaranteed by corporation *B*. The maturity dates of the bonds varied from two months to seven years. Held, the bonds were securities. In LeTulle v. Scofield, 308 U.S. 415, 60 S. Ct. 313 (1940), the Court held that an exchange of bonds alone did not constitute a reorganization because of