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CORPORATE REORGANIZATIONS: SOME CURRENT DEVELOPMENTS INCLUDING THE TAX REFORM ACT OF 1969

JOHN D. SHORS*

I. INTRODUCTION

Among the variety of acquisition techniques, the tax-free or partially tax-free exchange has proven an indispensable tool. Congress, in the various tax-free reorganization sections, has provided that where the taxpayer retains substantially the same investment after reorganization as before, the mere change in the form of investment is not a taxable incident.[1] A tax-free reorganization is thus essentially a tool for recognition postponement. While conforming to this policy of nonrecognition, Congress has provided further that some taxable gain must be recognized in certain exchanges called "tax-free" where the taxpayer is deemed to have made a significant shift in his investment which is not yet substantial enough to call for complete taxation. As is the general rule in other areas of nonrecognition, a continuing basis, adjusted to account for gain realized, goes hand-in-hand with tax postponement.[2]

The common tax-free acquisition methods are known as the Type A, Type B and Type C reorganizations. Typically, the Type A is a statutory merger or consolidation; the Type B is the acquisition of stock for voting stock while the Type C involves the acquisition of assets primarily for voting stock. As will be seen in the subsequent discussion, the Types A, B and C reorganizations each require that markedly different standards be met for tax-free treatment. Although there are distinctions in the tax requirements, the Types A, B and C reorganizations can produce similar corporate end products. For example, a Type C reorganization is commonly thought of as the acquisition of the *assets* of another corporation, not the acquisition of that corporate structure itself. A Type B reorganization, on the other hand, is the acquisition of another *corporation,* both the shell and assets. Yet upon the subsequent liquidation of the corporation acquired in

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[1] *See generally* Treas. Reg. § 1.1002-1(c) (1957); Hellerstein, *Mergers, Taxes, and Realism,* 71 HARV. L. REV. 254 (1957). As will be seen in the ensuing discussion, the reorganization sections encompass more than mere formal changes.

[2] This adjusted basis does not always result in taxation in the future. The most obvious breach of the concept is the step up in basis to fair market value at the taxpayer's death, with the gain not being taxed. I.R.C. § 1014. Another breach of the concept is that basis is not always adjusted in a reorganization to account for the gain shown. *See* Spillers & Shors, *The Role Of The Statutory Merger In Corporate Acquisitions: A Legal And Financial Inquiry,* 53 IOWA L. REV. 1, 70 (1967) [hereinafter cited as Spillers & Shors].

a Type B, the assets are transferred to the acquiring corporation and the end result often is indistinguishable from that of a Type C reorganization.[3] Under a doctrine entitled the "step transaction doctrine,"[4] the Internal Revenue Service (Service) may urge that a Type B reorganization followed by a liquidation is essentially a Type C and taxable, if the tests of a Type C are not met. The step transaction doctrine simply examines conditions both before and after a change in ownership, and if the series of transactions leading thereto are sufficiently related, considers the various transactions as a single transaction for tax purposes.

The step transaction doctrine thus blends uncertainty, sometimes unnecessarily, into the reorganization area. The purpose of this article is to briefly discuss the Types A, B and C reorganizations with particular emphasis upon current developments.

II. Several General Tests

A. *Continuity of Interest Test*

Although the tax-free Types A, B and C reorganizations are subject to varying standards, they share many common characteristics.[5] In Type A, and to some extent in the B and C reorganizations, the shareholders of the acquired corporation must retain a proprietary interest in the transferee corporation. This "continuity of interest"[6] has basically defined "stock" within the reorganization sections and may be satisfied by a continuing[7] proprietary-type interest of a certain magnitude which evidences the equivalence of stock through the sufficient use of preferred, common voting or nonvoting stock, and voting trust certificates.[8] The magnitude of interest required is satisfied if there is a continuing interest equal in value, at the effective date of the reorganization, to at least 50 percent of the value of

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[3] There can be distinctions: a corporation acquiring through a Type C can avoid liabilities, however this normally cannot be done in a Type B acquisition.

[4] For a discussion of the step transaction doctrines, see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders 557-63 (2d ed. 1966); Jacobs, *Supreme Court Further Restricts The Step Transaction Doctrine*, 29 J. Taxation 2 (1968); Shors, *The Role of the Subsidiary in Corporate Reorganizations*, 18 Drake L. Rev. 175, 193 (1969).

[5] For other considerations, see Gannet, *Tax Planning Guide to Alternatives Available in Corporate Expansion Alternatives*, 31 J. Taxation 278 (1969). *See* Tax Reform Act of 1969, Pub. L. No. 91-172, § 411(a) (Dec. 30, 1969) [hereinafter cited as 1969 Act].

[6] The continuity of shareholders' interest doctrine was firmly established in the case of Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (short-term purchase-money notes not sufficient interest), and followed by several decisions culminating with LeTulle v. Scofield, 308 U.S. 415 (1940) (cash plus bonds payable over 13 years not sufficient).

[7] A "continuing" interest means that the evidence of a proprietary interest must not be disposed of as part of a predetermined plan. *See* Morgan Mfg. Co. v. Commissioner, 124 F.2d 602 (4th Cir. 1941) (control pending payment of mortgage debt insufficient); Long Island Water Corp., 36 T.C. 377 (1961) (various related transactions will be examined together in determining whether continuity test met).

[8] For a discussion of the interests that satisfy the continuity of interest requirement see text accompanying notes 57-59 *infra*.

all of the formerly outstanding stock of the acquired or transferor corporation.[9] As will be seen, the Type B and C reorganizations have statutory consideration requirements which are more strict than the continuity of interest test.

The Tax Reform Act of 1969 grants the Service the power to promulgate regulations in determining whether an interest in a corporation is stock or indebtedness for purposes of Subchapter C, which encompasses the reorganization sections.[10] Consequently, under the new Act the Service may modify the consideration tests as we now know them. The enactment is thus of considerable significance in the reorganization area and will be discussed in some detail in this article. However, for purposes of clarity, the Type A, B and C reorganizations and other general matters relating thereto will be first discussed.

B. Boot

In a Type A and C reorganization it is possible that the shareholders of the acquired corporation may receive consideration other than stock in the acquiring corporation. The transferor shareholders have thus made some investment shift not in keeping with the congressional tax-free intent. In such case, that excess consideration, commonly called "boot," may have a tax incidence of its own. Boot includes: money, property, stock in any corporation other than the acquiring corporation or in some instances its parent,[11] excess securities including convertible securities involving original issue discount,[12] and property interests of all types.[13] If boot is present and there is any gain, it will be recognized to the recipient, but not in excess of the sum of money received or the fair market value of such other property.[14] The amount of boot, once determined, can be taxed under the normal criteria as a capital gain[15] under section 356 of the 1954 Internal Revenue Code (Code) unless the exchange has the effect of the distribution of a dividend, in which case it is taxed as such. The presence of earnings

[9] Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 334 (5th Cir. 1951); Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232.

[10] 1969 Act § 415.

[11] *See* note 67 *infra* and accompanying text.

[12] *See* Morreale, *Original Issue Discount: Guiding the Venture Company Through the Maze*, 32 J. TAXATION 2 (1970); 1969 Act § 413.

[13] I.R.C. §§ 354, 356. *See* Rev. Rul. 69-264, 1969 INT. REV. BULL. No. 21, at 6 (option to redeem own stock is boot).

[14] If in pursuance of a plan of reorganization, *R* exchanged stock which had cost him $5,000 and had a fair market value of $5,500, for shares of *Y* Company plus $200 in cash, of the $500 gain, only $200 is recognized. The basis of the *Y* shares is $5,000. If the fair market value of the *Y* stock had been $4,000, the loss of $800 would not be recognized and the basis of *Y* shares would be $4,800.

[15] Consideration here roughly discussed as a capital gain item can of course be an ordinary income item in whole or part if, for example, the holding period is inadequate, interest, real or imputed, is found, original issue discount is present, or other similar matters.

and profits in either the transferor or transferee corporation may produce that dividend effect.[16]

C. Preacquisition and Postacquisition Losses

A consideration of considerable importance in an acquisition is the existence of tax attributes in the acquired corporation and the use potential of such attributes. As may be the case in taxable transactions, in all Type A, B and C reorganizations there is some possibility of tax attribute carry-overs. Section 381, with numerous qualifications, provides that in both Type A and Type C reorganizations, the acquiring corporation will be treated in effect as the *transferor* corporation with respect to certain enumerated tax attributes.[17] Section 382(b) is a special section relating to loss carry-over and reduces the allowable amount of carry-over by 5 percent for each percent below 20 percent of the outstanding stock of the acquiring corporation which is received by the shareholders of the acquired corporation.[18] The case of *Libson Shops, Inc. v. Koehler*[19] required the ultimate beneficiaries of a tax attribute carry-over to be substantially the same persons who initially incurred the tax benefit involved. The Service has ruled that *Libson* will not be applied to transactions specifically covered by section 381(a) of the Code. An uneasiness concerning the strength of *Libson* has kept some planners from structuring an acquisition outside the boundary of section 381(a). Recently, however, several courts have taken the position that the 1954 Amendments were meant to do away in total with the effect of *Libson*.[20]

Another area of unpredictability concerns the use of the acquired corporation's post-acquisition losses by the transferee corporation. The Service had also urged, with success, in past years that where a company is acquired with a prior loss with the primary purpose of obtaining that loss, that the purpose also taints the post acquisition loss.[21]

However, where there is no motive to acquire the built-in losses, where the loss has not occurred either economically or in a tax sense prior to acquisition even though the losses could be anticipated, the post-acquisition losses should still be deductible. However, if it appears there is no eventual expectation of profit, the result should be to the contrary.[22]

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16 *See* BNA TAX MANAGEMENT MEMO 62-22 (Oct. 29, 1962). *See also* Davant v. Commissioner, 366 F.2d 829 (5th Cir. 1966).

17 I.R.C. § 381.

18 *Id.* § 382(b).

19 353 U.S. 382 (1957).

20 *See* United States v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968); Frederick Steel Co. v. Commissioner, 375 F.2d 351 (6th Cir. 1967). *But cf.* Frank IX & Sons Virginia Corp. v. Commissioner, 45 T.C. 533, *aff'd*, 375 F.2d 867 (3d Cir. 1967). *See generally* Liles, *New Case Reaffirms View That Libson Shops Doctrine Does Not Apply Under Present Code*, 26 J. TAXATION 322 (1967).

21 R.P. Collins & Co. v. United States, 303 F.2d 142 (1st Cir. 1962).

22 *See* Borge v. Commissioner, 405 F.2d 673 (2d Cir. 1968); Schecter, *Climate Is Im-*

D. Business Purpose and Section 269

The reorganization must also be pursuant to a business purpose rather than mere tax avoidance.[23] Yet the courts do not expect a taxpayer to purposely avoid tax saving devices and merely because the transaction does result in a tax saving obviously will not be grounds for invalidating the transaction.[24] The business purpose test has been supplemented by section 269 of the Code which states that if the principal purpose is the evasion or avoidance of federal income tax, the Service is empowered to disallow those deductions, credits and other allowances.[25] However, it has been held that nonrecognition of gain or loss in connection with sections 336 and 453 is not encompassed by the terms of the section 269 deduction, credit or allowance and that consequently, section 269 does not deal with nonrecognition concepts.[26] The logic is equally apt regarding the reorganization sections.

III. TYPE A REORGANIZATIONS

The Type A reorganization[27] is a merger or consolidation under state or federal law which also meets certain statutory and court-found tests under the Code.[28] The Type A in allowing tax-free treatment affords certain flexibility as opposed to other tax-free reorganizations regarding the

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proving For Deduction Of Postacquisition Losses, 31 J. TAXATION 202 (1969). For Carryback F. reorganization, see Home Constr. Corp. v. United States, 7 P-H 1969 FED. TAXES (24 AM. FED. TAX R.2d) ¶ 69-5266 (S.D. Ala. Nov. 10, 1969); Rev. Rul. 69-516, 1969 INT. REV. BULL. No. 41, at 10.

[23] Gregory v. Helvering, 293 U.S. 465 (1935). Treas. Reg. § 1.368-1(b),(c) (1955) (such transaction and such acts must be an ordinary and necessary incident of the conduct of the enterprise). Treas. Reg. § 1.368-1(c) (1955). *See* Survaunt v. Commissioner, 162 F.2d 753 (8th Cir. 1947). *Compare* Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949) (what is deemed best for the shareholders is deemed best for the corporation and vice versa) *and* Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962), *with* Cherry v. United States, 264 F. Supp. 969, 975 (C.D. Cal. 1967) (shareholders can act on their own).

[24] *See* Commissioner v. Morris Trust, 42 T.C. 779, 788 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966). *See also* Cherry v. United States, 264 F. Supp. 969 (C.D. Cal. 1967).

[25] I.R.C. § 269(a)(2).

[26] Cherry v. United States, 264 F. Supp. 969 (C.D. Cal. 1967).

[27] I.R.C. § 368(a)(1)(A). For state statutory standards, see, *e.g.*, ABA-ALI MODEL BUS. CORP. ACT § 65 (1960); IOWA CODE § 496A.68, *et seq.* (1966).

[28] A reorganization can encompass other transactions not immediately associated with it. Passbooks of a federal mutual savings and loan association which contain some proprietary interest may be exchanged for similar passbooks reflecting the same dollar amount in a Type A reorganization of the two mutual savings and loan associations under federal law. Rev. Rul. 69-3, 1969 INT. REV. BULL No. 4, at 6. The Service has ruled, however, that a merger between a savings and loan association having permanent shares of stock outstanding and a mutual savings and loan association will not give sufficient continuity of interest to the merging shareholder in the stock company, as that ownership in the stock company was much greater than the mere passbook account in the mutual savings and loan association. Rev. Rul. 69-6, 1969 INT. REV BULL. No. 4, at 7. *See also* Home Sav. & Loan Ass'n v. United States, 223 F. Supp. 134 (C.D. Cal. 1963); Rev. Rul. 55-305, 1955-1 CUM. BULL. 345, holding a statutory merger of a corporation for profit into a cooperative was nontaxable. *See also* Rev. Rul. 68-22, 1968-1 CUM. BULL. 142.

types of consideration which may be received by the acquired company's shareholders or the magnitude of assets that must be acquired in the merger.

In the Type A reorganization prior to the Tax Reform Act,[29] the judicially imposed continuity of shareholder interest test[30] discussed above was the only limit upon the consideration given. As will be discussed subsequently, it appears that the Tax Reform Act, which allows the Service to define "stock," should not substantially affect the allowable Type A consideration. Consequently, the consideration test in a Type A reorganization should be met by continuing proprietary interest in excess of 50 percent in value of that surrendered. The remainder of the consideration may be cash, property or any other type of consideration. Additionally, while there is no statutory requirement in a Type A reorganization as to the amount of the assets of the transferor corporation that must ultimately be acquired,[31] should relatively few assets be acquired, the Service may consider the transaction to be taxable.[32] Because of the variety of allowable consideration and the flexibility as to that which must be acquired, the Type A reorganization retains a certain margin of safety. The Type A is so pervasive that it may be found where the acquiring corporation has not anticipated it. In the case of *King Enterprises, Inc. v. United States*,[33] Minute Maid Corporation purchased the stock of Tenco on September 3 for a total consideration consisting of $5,550,000 in cash and notes, and shares of Minute Maid's common stock valued at $5,770,771, in what properly should have been a taxable transaction. In April, Minute Maid merged the company's four subsidiaries, including Tenco, into Minute Maid. The petitioner, a corporate selling shareholder of Tenco, reported the transaction as a tax-free Type A reorganization and the cash and notes received from Minute Maid as dividend income subject to the 85 percent intercorporate dividend, received a deduction,[34] and did not report any gain on the receipt of the Minute Maid stock. When challenged, the petitioner argued that the initial transfer, which by itself was taxable, was merely a step in a unified transaction

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[29] *See* notes 77-82 *infra* and accompanying text.

[30] The test was established in Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (short term purchase-money notes not sufficient interest), and was followed by several decisions culminating with LeTulle v. Scofield, 308 U.S. 415 (1940) (cash plus bonds payable over 13 years not sufficient). *See* notes 5-9 *supra* and accompanying text.

[31] It is possible to preliminarily "spin out" assets in a Type A. *See* Commissioner v. Morris Trust, 42 T.C. 779 (1964), *aff'd*, 367 F.2d 794 (4th Cir. 1966). *But cf.* Curtis v. United States, 336 F.2d 714 (6th Cir. 1964).

[32] *See* Treas. Reg. § 1.368-2(d)(1) (1955); Massee, *Section 355: Disposal of Unwanted Assets in Connection with a Reorganization*, 22 TAX L. REV. 439, 488 (1967). Yet neither the case of Curtis v. United States, 336 F.2d 714 (6th Cir. 1964) nor Commissioner v. Morris Trust, 367 F.2d 794, 802 (4th Cir. 1966) question the magnitude of property that must be acquired in a Type A reorganization.

[33] 7 P-H 1969 FED. TAXES (24 AM. FED. TAX R.2d) ¶ 69-5240 (Ct. Cl. Nov. 14, 1969).

[34] I.R.C. § 243(a).

qualifying as a Type A reorganization.[35] The court found a Type A reorganization and thus allowed a shareholder, selling in a transaction supposed by the buyer to be taxable, to receive tax-free treatment. The seller might thus prevent the buyer from receiving benefits of a taxable purchase, including a step up in basis.[36] The *Minute Maid* court further held that the 85 percent dividend received deduction applied to the notes and cash received by the corporate selling shareholder of Tenco. The availability of the deduction thus allowed the corporate shareholder to receive boot, normally fully taxable as a dividend or if not equivalent to a dividend then at capital gains rates, if appropriate, at an effective rate substantially below either. The dividend received deduction when coupled with the 50 percent allowable boot in a Type A would allow substantial cash to change hands in a reorganization with minimal tax impact. In some instances, in an effort to receive the dividend deduction on merger, the individual stockholders of the corporation to be merged might early transfer their stock to a corporation which they controlled.[37] The step transaction doctrine might prevent success, although the transaction would seem appropriate.

IV. Type B Reorganization

A Type B[38] reorganization is simply a stock-for-stock acquisition in which no consideration, except cash for fractional shares, other than voting stock can be given by the acquiring corporation.[39] The voting stock may be common or preferred, but flexibility of consideration basically terminates at that point. Additionally, voting stock received and placed in a voting trust may not qualify for tax-free treatment.[40] The Service has apparently taken the position for ruling purposes that stock, to be considered voting stock, must carry voting powers comparable to the proportionate equity interest represented by that stock.[41] It is debatable whether the Service could sustain its position in a court test.[42] Further, the Tax Reform Act[43] while allowing the Service to determine the difference between "stocks" and "securities" did not authorize it to promulgate regulations defining "stock"

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35 Although conceding there was no binding commitment to take the next step, for a discussion of the step transaction doctrine, see note 4 *supra* and accompanying text.

36 Minute Maid had in the meantime received a ruling that it could receive a 334(b)(2) step up in basis on Tenco's disappearance.

37 It should be remembered that the boot received in the reorganization qualifying for the dividend deduction could also qualify as personal holding company income. Persons desiring the dividend deduction would be well advised to make certain that the parent of the company to be acquired avoids the personal holding company tests.

38 I.R.C. § 368(a)(1)(B).

39 Rev. Rul. 66-365, 1966-2 Cum. Bull. 116.

40 *See* BNA Tax Management Memo 69-11, at 13.

41 *See* BNA Tax Management Memo 69-12, at 12.

42 For an interesting definition of voting stock, see Forrest Hotel Corp. v. Fly, 112 F. Supp. 782, 789 (S.D. Miss. 1953) (common stock had no voting rights because of arrearages on preferred, and preferred stock had voting rights because of the same arrearages; both held to be voting stock).

43 *See* text discussion at p. 18, *infra*.

and "voting stock." After the acquisition, the acquiring corporation must have control, defined as 80 percent, of all classes of stock in the acquired corporation.[44] It is possible in a Type B reorganization to purchase the acquired corporation's stock for cash in an early transaction and to obtain the remainder of the necessary amount in an unrelated transaction, solely in exchange for voting stock.[45] However, the definition of an unrelated transaction is uncertain. The Service apparently will not issue an advance ruling if there is a previous acquisition of stock in the company to be acquired for cash in a transaction consummated within 12 months of the purported B reorganization.[46] The Service has held that stock of *Y* received in liquidation of a subsidiary *X* by parent *P* was not received for stock of *P*.[47]

Any attempt to have the shareholders of the acquired corporation receive for their stock anything other than voting stock of the acquiring corporation normally leads to difficulty, although the payment by an acquired corporation to its shareholders of a regular year-end dividend, declared prior to the exchange, is permissible.[48]

Note, however, that section 368, in defining the Type B reorganization, defines it as the acquisition by one corporation in *exchange* solely for all or a part of its voting stock of the "*stock*" of another corporation. In Revenue Ruling 69-91[49] the Service allowed presently outstanding convertible debentures of the acquired corporation to be purchased for cash in connection with the reorganization. The Service ruled that the debentures were not stock and consequently need not be acquired for voting stock. Similarly, in Revenue Ruling 69-142[50] the Service ruled than an issue of 6 percent, 10 year debentures of the acquired corporation then outstanding could be exchanged for equal amounts of similar debentures of the acquiring corporation in connection with a Type B reorganization.

Both of the above rulings noted that the debentures were held largely or entirely by non-stockholders of the company. However, the question of who is holding the debentures is only of interest in resolving the question of whether shareholders received something other than voting stock for their *stock*. Obviously, if none of the debentures are held by shareholders, shareholders did not in fact receive other consideration for their *stock* through payment for the debentures. The question is one of proper valua-

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44 I.R.C. § 386(a)(1)(B).

45 However, in noting the gradual takeover, Treas. Reg. § 1.368-2(c) (1955) separates the cash transaction from the stock-for-stock transaction by some sixteen years. *Symposium: Tax-Free Corporate Reorganizations*, 19 CASE W. RES. L. REV. 974 (1968). Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, sets forth certain operating rules for issuing ruling letters.

46 BNA TAX MANAGEMENT MEMO 69-07, at 12.

47 Rev. Rul. 69-294, 1969 INT. REV. BULL. NO. 23, at 10.

48 Rev. Rul. 69-443, 1969 INT. REV. BULL. NO. 34, at 10.

49 1969 INT. REV. BULL. NO. 9, at 12.

50 1969 INT. REV. BULL. NO. 13, at 8.

tion in order to be certain that the cash given for the debentures was not in reality given for stock. It should be further noted that the debentures were purchased by the acquiring corporation directly, not through transfer of cash to the acquiring corporation.[51]

Under the Tax Reform Act, the Service has the opportunity to promulgate regulations establishing what is stock and what is a security. It would seem, however, that the logic of the above rulings would presently allow stock rights,[52] warrants,[53] and options[54] to be purchased in a Type B for cash. If the above items could be acquired for cash, a fortiori they could be acquired for debentures or nonvoting stock of the acquiring company.[55] It would appear that certificates of contingent interest,[56] or convertible or nonconvertible preferred stock could not presently be so purchased, as they appear the equivalent of stock and must be obtained for voting stock. The Service's new ability to promulgate regulations to determine whether an interest in a corporation is stock or a security was intended to and may indeed, be helpful in resolving the question of what can be purchased and what must be acquired for voting stock in the Type B.

Normally, cash given in a Type A or C reorganization is treated as boot and taxed, if there is a gain, at dividend or capital gain rates.[57] Section 356 describes boot, stating simply that if section 354 or 355 would apply to an exchange but for the presence of other property, it will be treated as boot. Section 354 contains the language that "[I]f stock or securities . . . are in pursuance of the plan of reorganization, exchanged. . . ." The Service in Revenue Ruling 69-142[58] found that the debentures were securities within 354(a)(1) which, it would seem, would make cash received for them boot, as in a Type A or Type C. The facts stated in the ruling were: "*Pursuant to the plan of reorganization,* X acquired all of the outstanding debentures of Y." Yet the Service found that the acquisition of the debentures "was not part of the reorganization exchange" and that consequently 354(a)(1) was not applicable. The Service thus strangely[59]

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51 *See* BNA TAX MANAGEMENT MEMO 69-25, at 13.

52 *See* Bann v. Commissioner, 51 T.C. 105 (1968).

53 *See* Treas. Reg. § 1.35401(e) (1955).

54 *See* LeVant v. Commissioner, 45 T.C. 185 (1965), *aff'd*, 376 F.2d 434 (7th Cir. 1967).

55 1969 INT. REV. BULL. NO. 13, at 8.

56 *See* Spillers & Shors at 59.

57 *See* note 15 *supra* and accompanying text.

58 *See* discussion at notes 11-16 *supra* and accompanying text.

59 A similar problem was recently posed in the case of LeVant v. Commissioner, 45 T.C. 185 (1965), *aff'd*, 376 F.2d 434 (7th Cir. 1967), in which the taxpayer had an option to purchase a 20 percent interest in a company. The company was acquired in what apparently was a Type B reorganization and the taxpayer attempted to transfer his option tax-free for shares of the acquiring corporation. In this case, all that was transferred by the acquiring corporation was voting common stock in return for all the stock of the acquired corporation. Consequently, the court did not concern itself with the type or propriety of the reorganization, but rather with § 354 and the question of whether the stock option was a stock or security which apparently could be transferred tax-free in the Type B. Here the item in question is clearly a security and it would seem

ruled that such a purchase produces not boot but gain or loss under section 1001 of the Code.[60] The Service seemed to ignore section 354 which broadly includes the exchange of stock or securities pursuant to a "plan of reorganization." This exchange, by definition, was pursuant to such a plan and the definitional test of section 368 was met. The exchange then should have been permissible under section 354. It is submitted that the Service erred, for under its own view, even if the debentures were acquired for voting stock, there would be a gain under section 1001.[61] This would not be the case if the transfer were within section 354, as the author feels it is. Nor would there be a gain on the exchange of securities for securities within section 354 if the principle amount received did not exceed the principle amount surrendered. However, under the Service's view, in some situations in which cash for debentures in a Type A or C would produce boot and dividend consequences, the use of a Type B reorganization might produce lesser capital gain. The Type B reorganization, in any event, now affords some interesting flexibility.

A situation recently arose in which the Service would seem to have inadvertently made a damaging concession. Arthur McDonald[62] owned all of the outstanding nonvoting preferred stock, which apparently received dividends at the rate of 6 percent, and substantially all of the outstanding common stock of *X* Corporation. McDonald entered into an agreement with Borden under which *X* Corporation redeemed its preferred stock at par, which was its basis, and thereafter Borden acquired all of *X*'s common stock in exchange for its own common stock in a Type B reorganization. Although, as just stated, debentures can be purchased if not additional consideration for stock, section 368 of the Code states that stock must be acquired for voting stock. It would seem that the Service by invoking the step transaction doctrine[63] to urge that the cash redemption of the preferred stock was part of the transaction could have argued that the Type B failed and the transaction was therefore taxable. Curiously, it did not. Rather, conceding that the Type B was valid, the Service urged that the earlier redemption was a separate transaction and accordingly was substantially equivalent to a dividend. The tax court found that the redemption was part of the termination of an interest, as it was coupled with the reorganization. Consequently, McDonald had no tax incident on the exchange of his preferred stock at its basis of $43,000 and no tax on the exchange of his common stock for Borden's stock. It would seem unadvisable to pattern a reorganization after McDonald; the Service could not be expected to miss the opportunity to attack a similar transaction within the Type B context

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should have been taxed as boot if there was gain and tax-free if acquired for voting stock.

60 I.R.C. § 1001.

61 *See* Rev. Rul. 70-41, 1970 INT. REV. BULL. No. 4, at 10.

62 Arthur D. McDonald & Jessie L. McDonald, 52 T.C. No. 8 (1969).

63 *See* discussion at note 4 *supra* and accompanying text.

again. However, if a redemption were coupled with a Type A reorganization and the boot were less than 50 percent of the total consideration, it would seem there would then be no risk. If the redemption was unsuccessful and held to be boot in the Type A, the taxpayer would only pay what he would have paid anyway.[64] It is submitted that the odds of success are not substantial, however, as the step transaction doctrine would normally be applicable.[65]

V. Type C Reorganization

We have noted that in the Type A statutory merger the consideration test allows up to 50 percent boot. In the Type B reorganization *stock* of the acquired corporation must be obtained solely through the use of voting stock, but outstanding debentures can be acquired for cash in some instances. The Type C[66] reorganization is the acquisition by one corporation of *substantially* all the assets of another corporation in exchange "primarily" (rather than "solely" as in the case of the B) for voting stock of the acquiring corporation. However, if other voting stock, "boot," is used by the acquiring company, then that which is the "substantially all" which must be acquired, instead of being a case law test, becomes the stricter statutory 80 percent test.[67] Thus if boot is used in a Type C reorganization, the property acquired must comprise at least 80 percent of the fair market value of all the property of the transferor. Assumed liabilities need not be treated as boot if there is no other boot, but the assumed liabilities must likewise be within the 20 percent test. Where the acquiring corporation has previous ownership in the acquired corporation, a Type C reorganization may not be available because the acquisition may be held as partly in liquidation rather than an exchange of voting stock.[68] Pre-existing ownership problems, however, are generally solvable once recognized.[69] Upon the preplanned liquidation of the acquired subsidiary in a Type B reorganization, the step transaction may require that there is in reality a C reorganization which, because of the different tests, can result in tax liability.

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[64] In a Type A, 50 percent boot is allowable.

[65] The court also commented repeatedly that McDonald had not suggested the cash payout, that it was Borden's decision, but it reserved ruling on whether there would be a difference in result. It would seem that there should be none.

[66] I.R.C. § 368(a)(1)(C). For an expanded treatment, see Spillers & Shors at 25-28.

[67] I.R.C. § 368(2)(B)(iii). *See* Spillers & Shors at 27.

[68] Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959). For similar dealing with parents (*P*) liquidation of a sub *X* holding stock of *Y* and *P*'s stock for stock exchange with the remaining shareholders of *Y*, *see* Rev. Rul. 69-294, 1969 Int. Rev. Bull. No. 23, at 10. *But see* Rev. Rul. 69-619, 1969 Int. Rev. Bull. No. 50, at 12.

[69] This is true of the Type A reorganization. For others see B. Bittker & J. Eustice, *supra* note 4, at 566. *See also* Rev. Rul. 69-617, 1969 Int. Rev. Bull. No. 50, at 10.

VI. STOCK OR SECURITIES: THE TAX REFORM ACT OF 1969

In all types of reorganization the definition of the words "stock or securities" is of prime importance. Because of the impact which the Tax Reform Act has upon the definition of "stock or securities," the applicable section is set out below:

SEC. 415. TREATMENT OF CERTAIN CORPORATE INTERESTS AS STOCK OR INDEBTEDNESS.

(a) IN GENERAL. — Subchapter C of Chapter 1 (relating to corporate distributions and adjustments) is amended by redesignating part VI (relating to effective date of subchapter C) as part VII and by inserting after part V the following new part: . . . .

SEC. 385. TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS.

(a) AUTHORITY TO PRESCRIBE REGULATIONS. — The Secretary or his delegate is authorized to prescribe such regulations as may be necessary or appropriate to determine whether an interest in a corporation is to be treated for purposes of this title as stock or indebtedness.

(b) FACTORS. — The regulations prescribed under this section shall set forth factors which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations may include among other factors:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money's worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) the relationship between holdings of stock in the corporation and holdings of the interest in question.

(c) CLERICAL AMENDMENT. — The table of parts for subchapter C of chapter 1 is amended by striking out the last line and inserting in lieu thereof the following:

Part VI. Treatment of certain corporate interests as stock or indebtedness.

Part VII. Effective date of subchapter C.[70]

As previously noted, prior to the Tax Reform Act, stock has been defined through the continuity test. The congressional concern in the new enactment was largely directed to the present classification of some interests, basically of stock interests, as debt interests, with accompanying advantages

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70 1969 Act § 415.

to the acquiring corporation, including interest deduction and basis step-up. Thus, if the Service makes only a uniform regulation under the Tax Reform Act, it would be anticipated that the definition of "stock," now defined by the continuity test, might become broader.

The enacted provision did not appear in the House Bill.[71] The Senate committee reported that it found, because of differing circumstances in different situations, that it would be difficult to provide comprehensive and specific statutory rules of universal and equal applicability. The committee Bill authorized the Secretary "to prescribe the appropriate rules for distinguishing debt from equity in *these different situations.*" Yet the committee also states, "[t]he guidelines to be promulgated by the Secretary of the Treasury are to be applicable for *all purposes of the Internal Revenue Code.*"[72] The enactment states the Service is authorized to determine "whether an interest in a corporation is to be treated for purposes of this *title* as stock or indebtedness."[73] It would seem, based on the above language, that the Service is limited to one test or set of tests of uniform applicability throughout Subchapter C. If it were not such, and an interest in a corporation might be stock for purpose of one section in Subchapter C and a security for purposes of another section, the clarification step would be an undesirable step in the wrong direction.

Regardless, the question arises as to the impact of the Act as it relates to the Types A, B and C reorganizations.

In the Type B and Type C reorganization, voting *stock*, as has been seen, is basically the only allowable consideration. This voting stock consideration limitation is made part of the reorganization by virtue of the very definitions in section 368(a) of the Type B and Type C reorganizations.[74] Voting stock as used in the Type B and Type C will obviously be directly affected by the Service's regulations. Section 368(a) defines an A reorganization only as "(A) a statutory merger or consolidation."[75] Thus, the word "stock" does not appear in the Type A statutory definition. The case of *Pinellas Ice & Cold Storage Co. v. Commissioner*[76] found the need for a continuing proprietary interest in the Type A but did not find a need for something called "stock," as such.

The continuity test is one of both magnitude and type of consideration. The Tax Reform Act will clearly not affect the magnitude test. Thus 50 percent boot will still be allowable in a Type A reorganization. The question is whether the required 50 percent proprietary interest would yet

[71] H.R. 13270, 91st Cong., 1st Sess. (1969).

[72] S. REP. No. 552, 91st Cong., 1st Sess. (1969) (emphasis added). *See also* H.R. REP. No. 782, 91st Cong., 1st Sess. 5493 (1969) (remarks of Hon. Edwin Cohen).

[73] I.R.C. § 385(a) (emphasis added).

[74] I.R.C. § 368(a).

[75] *Id.*

[76] 287 U.S. 462 (1933).

be defined in the present manner or whether it would be affected by the Service's regulations.

Briefly stated, the following is arguable: that the intent of Congress is to substitute the judgment of the Service for that of the courts in every aspect of Subchapter C as to the definition of stock or securities. The court found requirement, called the continuity test, is one of a proprietary interest in a Type A reorganization. The continuity test is a definition of "stock" as opposed to "indebtedness." Section 385 thus also affects the court-found test of proprietary interest in the Type A reorganization.

It would seem to this writer that the following is more arguable: that "continuity of interest," not "stock," has been required in the Type A reorganization. The continuity test is one of magnitude and type of consideration. The fact that the type of consideration portion of the test has served to define stock does not mean that a definition of "stock" necessarily defines "continuity of interest." If Congress had intended to overrule such a long-standing test as the continuity test, it should have done so more explicitly. Consequently it would appear that the continuity of interest standard should not be modified by the Service regulation.

Even with the latter assumption, however, the shareholders of the acquired corporation in the Type A must rely upon section 354 set out above to achieve their tax-free exchange. Section 354 allows "stock or securities" to be exchanged for "stock or securities." Securities may be exchanged tax-free only in amount not in excess of the securities surrendered. If the Service's definition of "stock" were broader than this continuity test, any consideration allowable for the continuity test would not be taxable as boot under Sections 354 and 356. If the Service's test was narrower than the continuity test, where the continuity test was met and the acquiring corporation transferred like stock and securities for like stock and securities in equal proportions within the Service's definition, or where excess stock was given to the acquired company shareholders, there should be no boot tax impact. If the Service's test was narrower, an incident of ownership in the acquiring corporation meeting the continuity test but not meeting the Service's definition of stock transferred for incidence of ownership of the acquired corporation deemed "stock" by the Service, will be taxable as boot under section 354, even though all of the above described consideration meets the continuity of interest standard. Of course, if the continuity test was held to be modified by the Tax Reform Act, the projected discrepancy between "consideration" and section 354 would not exist.

Hopefully, the Service will be limited to but one definition for "stock" and one definition for "securities" for all of Subchapter C, and that the definitions will both simplify and clarify. However, the planner should bear in mind that the Service's definition will work both ways in the reorganization area. For example, if stock is narrowly defined, the corporate dividend

exclusion may minimize the tax impact of boot in the Type A for the corporate shareholder and purchase of other than stock in a Type B will sometimes be acceptable. If stock is more broadly defined than it is now, it seems the Service should not under its enabling legislation be able to separately define voting stock, and the consideration of the Types B and C should be expanded. Whether the consideration for the Type A reorganization would also be expanded is debatable. It is unfortunate that the language of the Tax Reform Act is not more specific.

VII. Subsidiaries

The Code also provides that transactions otherwise qualifying as Type A, Type B or Type C reorganizations will not be disqualified by reason of the fact that part or all of the assets or stock acquired were subsequently transferred to a corporation controlled by the acquiring corporation.[77] Thus, for a Type A, Type B or Type C reorganization the assets can be transferred after acquisition to a corporation controlled by the transferee.

Additionally, in Type B and C reorganizations the term "a party to the reorganization" includes a corporation controlling the acquiring corporation. The impact of this provision is that under one of the general definitional provisions dealing with tax-free reorganizations, "[n]o gain or loss shall be recognized if stock or securities in a corporation are . . . exchanged for stock or securities in . . . [a] corporation a party to the reorganization."[78]

Consequently, an acquiring subsidiary may in a Type B or Type C reorganization use the stock of its parent in making an acquisition. Similarly, a recent enactment allows stock of the parent to be used in certain types of Type A reorganizations.[79] Yet the language of the new enactment poses some problems within the Type A reorganization and it appears questionable whether all of the flexibilities of the Type A are continued.[80] The enactment includes "an acquisition of substantially all of the assets" test which has been the test of the Type C reorganization, not the Type A. Substantially all could be interpreted under the same case law as the Type C reorganization discussed previously. However, it appears the Service will allow the 50 percent boot of the Type A reorganization, and that position seems the proper one.[81] The step transaction has considerable applicability in the subsidiary area and a planner proceeding in it is well advised to carefully consider that doctrine.

VIII. Conclusion

The reorganization area is broadening. For example, the ability to sometimes purchase debentures in a Type B reorganization, the dividend

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[77] I.R.C. § 354.

[78] *Id.* § 354(a)(1).

[79] *Id.* § 368(a)(2)(c). *See generally* Shors, *supra* note 4.

[80] *Id.* § 368(a)(2)(D). *See* BNA Tax Management Memo. 69-24, at 11; BNA Tax Management Memo. 69-08, at 11. *See generally* Shors, *supra* note 4.

[81] *See* BNA Tax Management Memo. 70-06, at 13.

exclusion for corporate stockholders, and the use of a subsidiary in a Type A reorganization all make the reorganization more usable. Some unnecessary distinctions remain, however.

Some years ago the Advisory Group on Subchapter C of the Internal Revenue Code of 1954[82] recommended a modification of the continuity of interest test and relaxation of the "solely for voting stock" test. The Advisory Group also felt that the test should be on economic continuity of interest either common or preferred rather than a right to vote in corporate matters. The Tax Reform Act of 1969 may have made a step in this direction.

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82 *See* REVISED REPORT OF THE ADVISORY GROUP ON SUBCHAPTER C OF THE INTERNAL REVENUE CODE OF 1954.