

Taxation of Reorganizations Under Section 112(i)(1)(B) of the Revenue Act

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TAX COMMENT

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TAXATION OF REORGANIZATIONS UNDER SECTION 112 (i) (1) (B) OF THE REVENUE ACT.—Prior to the Revenue Act of 1918 the federal income tax laws did not contain any provisions expressly relating to reorganizations of corporations. Although "income" was defined as a gain derived from capital which had been "severed from capital" and "received or drawn by recipient for his separate use" and, "not a growth or increment in value of capital holding,"¹ later decisions did not deal liberally with assets acquired through reorganizations. Transfer of stock in one corporation for stock in another corporation was held to result in a taxable gain to the stockholder where the assets transferred to the new corporation included accumulated surplus² or where the issue of stock was of greater value than the stock of the transferor corporation.³

The Revenue Act of 1918⁴ attempted to relieve those interested in reorganizations from a profit tax where there was only a change in corporate form without an actual realization of gain. But under this statute the court denied stockholders the exemption where the new stock was in a corporation organized in a foreign state⁵ or where the stock received was of greater par value than that of the assets transferred,⁶ although where stock and cash were issued for the assets of the old corporation the stock was not considered a gain.⁷

¹ *Eisner v. Macomber*, 252 U. S. 189, 40 Sup. Ct. 189 (1920).

² *United States v. Phellis*, 257 U. S. 156, 42 Sup. Ct. 63 (1921). Where the assets of a New Jersey corporation were transferred to a Delaware corporation and the Delaware corporation exchanged at the rate of 2:1 its stock for that of the New Jersey corporation.

³ *Rockefeller v. United States*, 257 U. S. 176, 42 Sup. Ct. 68 (1921). Old corporation transferred part of its assets to new corporation in consideration of entire issue of stock. The stock was immediately issued to the stockholders.

⁴ Rev. Act of 1918, §202 (b), 40 Stat. 1060, 26 U. S. C. A. §1219 (b). "When in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities of no greater aggregate par or face value, * * * the new stock * * * shall be treated as taking the place of the stock, securities or the properties exchanged."

⁵ *Marr v. United States*, 268 U. S. 536, 45 Sup. Ct. 575 (1925). A corporation was organized in Delaware to take over the assets of a New Jersey corporation and issued its stock in a ratio of 5:1. The court held that the taxpayer acquired interests in a foreign corporation which is subject to different rights and powers as a corporate organization.

⁶ *Insurance and Title Guarantee Co. v. Commissioner*, 36 F. (2d) 842 (C. C. A. 2d, 1929). The difference between the par value and the assets transferred was considered as a taxable gain to the stockholder.

⁷ *Weiss v. Stearn*, 265 U. S. 242, 44 Sup. Ct. 490 (1924). The cash was held to be a dividend but the stock was a direct exchange. "We cannot con-

The Revenue Act of 1921⁸ supplemented the Act of 1918 with a definition of reorganization which "contained some recognition of the principle that readjustments of corporate forms of reorganization which did not substantially affect the property interests either of the shareholders or of the corporations, should, in general, be permitted to go through without income tax liability."⁹ The Revenue Act of 1924¹⁰ with the purpose of promoting ordinary business transactions¹¹ allowed for the widest possible latitude in reorganizations by embracing within the definition of "reorganization" the case of a transfer of all or part of the assets, if immediately after the transfer the transferor is in control of the transferee corporation.¹² Under this Act and the subsequent Acts of 1926¹³ and 1928 the government would not have recognized any gain in the *Rockefeller*¹⁴ and *Phellis*¹⁵ cases, for the statute provides that:

"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"¹⁶

and, particularly, one of the definitions of reorganization describes

"a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer, the transferor or its stockholders or both are in control of the corporation to which the assets are transferred."¹⁷

clude that mere change for purposes of reorganization in the technical ownership of an enterprise * * * followed by issuance of new certificates, constitutes gain separated from the original capital interest" (at 254).

⁸ 42 Stat. 227, 26 U. S. C. A. §934.

⁹ Magill, *Notes on the Revenue Act of 1924* (1924) 24 COL. L. REV. 844, 845.

¹⁰ §203 (c), 43 Stat. 253, 26 U. S. C. A. §934.

¹¹ Ways and Means Committee, Rep. No. 179, 6th Cong., 1st Sess., Ser. No. 8226 (1924) 13. "Congress has heretofore adopted the policy of exempting from tax the gain from exchange made in connection with a reorganization, in order that ordinary business transactions will not be prevented, on account of the provisions of the tax law."

¹² House Committee on Ways and Means, Rep. No. 179, 68th Cong., 1st Sess. at 16 (1924). "The only change in the definition is to include within its terms the case of a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders, or both, are in control of the corporation to which the assets are transferred. This is a common type of reorganization, and clearly should be included within the reorganization provisions of the statute."

¹³ 44 Stat. 9, 109, 110, 26 U. S. C. A. §§934, 935.

¹⁴ *Supra* note 3.

¹⁵ *Supra* note 2.

¹⁶ REV. ACT OF 1928, §112 (b) (3), 45 Stat. 791, 816, 818, 26 U. S. C. A. §2112 (b) (3).

¹⁷ REV. ACT OF 1928, §112 (i) (1) (B), 26 U. S. C. A. §2112 (i) (1) (B).

and control is defined as

"the ownership 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 the corporation."¹⁸

Although we confine ourselves to a particular type of reorganization the statute includes merger or consolidations,¹⁹ recapitalization,²⁰ or a mere change of identity or form.²¹ The statutes have been drawn carefully and in minute details and state exactly how each step of a reorganization should be treated for tax purposes.²² But whether a particular transaction is a reorganization or a sale,²³ or a distribution of dividends²⁴ has raised a conflict in the courts that has left experts without any prophecies as to particular situations.²⁵ It appears, however, that under the definition of reorganization—Section 112 (i) (1) (B)—where there is a transfer of either

¹⁸ REV. ACT OF 1928, §112 (j), 26 U. S. C. A. §2112 (j).

¹⁹ REV. ACT OF 1928, §112 (i) (1) (A), 26 U. S. C. A. §2112 (i) (1) (A).

²⁰ REV. ACT OF 1928, §112 (i) (1) (C), 26 U. S. C. A. §2112 (i) (1) (C).

²¹ REV. ACT OF 1928, §112 (i) (1) (D), 26 U. S. C. A. §2112 (i) (1) (D).

²² Hendricks, *Taxation of Reorganizations* (1934) 34 COL. L. REV. 1199. In a statement published for the use of the House Ways and Means Committee in the latter part of 1933, Mr. Morgenthau, Acting Secretary of the Treasury, stated that reorganization provisions "had the disadvantage of leaving the Department no leeway in the administration of the law."

²³ Cortland Specialty Co. *et al.* v. Commissioner, 60 F. (2d) 937 (C. C. A. 2d, 1932). The acquisition of assets for cash and short term securities is a sale, even though all the assets were transferred. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U. S. 462, 53 Sup. Ct. 257 (1933). Holding under similar circumstances to the same ruling as in the Cortland case. Prairie Oil and Gas Co. v. Motter, 66 F. (2d) 309 (C. C. A. 10th, 1933). Where all the property was acquired through the purchase of stock, the court treated it as a sale because of lack of continuity of interest. Minnesota Tea Co. v. Commissioner, 28 B. T. A. 106 (1933). Holding that a transfer of all the assets was not sufficient for a reorganization where control element is lacking. Watts v. Commissioner, 28 B. T. A. 148 (1933), similar holding. C. H. Mead Coal Co. v. Commissioner, 72 F. (2d) 22 (C. C. A. 4th, 1934). Construed the transaction as a merger where the assets were acquired by foreclosure in pursuance of a financial plan of reorganization, although there was no controlling interest in the transferor's stockholders. Rogers v. Strong, 72 F. (2d) 455 (C. C. A. 3d, 1934). *Held*, that a transaction in which two corporations acting in consort exchanged their stock for stock in the controlled corporation, was a sale.

²⁴ Lonsdale v. Commissioner, 32 F. (2d) 537 (C. C. A. 8th, 1929). Where the bank corporation's dividends were applied at the request of the stockholders to the purchase of stock in a corporation created for the purpose of carrying on a function prohibited to the bank, it was held to be a distribution of dividends, as it was a transfer of stockholders' and not corporate property. Fred Barker, 28 B. T. A. 657 (1933). Holding that cash and stock distributed in pursuance of a reorganization is not a liquidating dividend.

²⁵ Hendricks, *Definition of Reorganization* (1932) 45 HARV. L. REV. 648, 649.

part or all of the assets to a corporation by an individual,²⁶ partnership,²⁷ or one or more corporations,²⁸ and there is immediate control of the entire issue of stock²⁹ by the transferor, there should apparently³⁰ be a reorganization within the statute.³¹

In the recent case of *Gregory v. Helvering*³² the taxpayer, as sole stockholder of corporation *A*, transferred part of the assets consisting of shares in *Z* corporation to the *B* corporation which had been purposely organized for this transaction, and which issued, in consideration of the assets, its entire stock to the taxpayer, who thereupon—within three days—caused the *B* corporation to be dissolved and received as a liquidating dividend the shares in *Z* corporation. The taxpayer asserts a “reorganization” and urges that under Section 112 (g) of the Revenue Act of 1928,³³ “If there is distributed, in pursuance of a plan of reorganization, to a stockholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without surrender by such stockholder of stock or securities in such corporation, no gain³⁴ to the distributee from the receipt of such stock or securities shall be recognized” and therefore she should be taxed only on their value less the cost properly allo-

²⁶ *T. W. Phillips, Jr., Inc. v. Commissioner*, 63 F. (2d) 101 (C. C. A. 3d, 1933). Holding that a transfer by an individual of all of his assets to a corporation formed to hold such assets was a reorganization and cost of assets to individual is cost basis to the corporation.

²⁷ *Conrad & Co., Inc. v. Commissioner*, 50 F. (2d) 576 (C. C. A. 1st, 1931). A partnership transferred to a corporation all its assets in exchange for the entire issue of stock. Reorganization resulted.

²⁸ *American Compress & Warehouse Co. v. Bender*, 70 F. (2d) 655, 657 (C. C. A. 5th, 1934). Where two corporations, as transferors, jointly held control of stock exchanged for assets, the court held that “The statute deals with a transaction whereby the relation of one or more persons to property is so changed.”

²⁹ *West Texas Refining & D. Co. v. Commissioner*, 68 F. (2d) 77, 80 (C. C. A. 10th, 1933). The outstanding stock was delivered to the transferor, but at the same time the transferee was under contract to issue stock to a third party which would limit the transferor's control to 50 per centum. Said the court, “It is intended to apply to cases where a corporation in form transfers its property, but in substance it or its stockholders retain the same interest after the transfer.” Here there was no reorganization.

³⁰ *Cf. Hendricks, Definition of Reorganization* (1932) 45 HARV. L. REV. 664. “There can never be a transfer of less than substantially all the properties or assets, unless there is control by the transferor or its stockholders or both.”

³¹ General Consul of the Bureau of Internal Revenue, C. C. M. 1753 (1927). “Again, a transfer of but part of the assets of a corporation can never of itself result in a reorganization under Sec. 203 (h) (1) (A), but it does result in a reorganization under Sec. 203 (h) (1) (B) if there is present an additional element, namely immediate control of the transferee or its stockholders, or both.”

³² 69 F. (2d) 809 (C. C. A. 2d, 1934), *aff'd*, 55 Sup. Ct. 266, — U. S. — (1935).

³³ 45 Stat. 818, 26 U. S. C. A. §2112 (g).

³⁴ Our italics.

cated.³⁵ The court held that this transaction was not a reorganization and the distribution is subject to the surtax on dividends, as "it does not follow that Congress meant to cover such a transaction, not even though the facts answer the dictionary definitions of each term used in the statutory definition,"³⁶ although the Eighth Circuit held that "if a definition of the word is given in the statute, that definition is controlling."³⁷ The court agrees that there may be an avoidance³⁸ of the tax law if the device is carried out by means of legal forms³⁹ where the element of fraud⁴⁰ or concealment⁴¹ in fact is lacking, but insists that the readjustment must be "undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution."⁴² Mr. Justice Sutherland, speaking for the United States Supreme Court, terms the transaction "an elaborate and devious form of conveyance masquerading as a corporate reorganization. To hold otherwise would be to exalt artifice above reality."⁴³

It is submitted that the court introduced a new factor—*intention*⁴⁴—into the statute. It is a factor that will not lead to feasible results⁴⁵ and one that supports a conclusion that "In considering exemptions from taxation we should bear against the taxpayer,"⁴⁶ and that the "Supreme Court has set up two conflicting lines of decisions re-

³⁵ REV. ACT OF 1928, §115 (c), 26 U. S. C. A. §2115 (c). Cost equals that proportion of taxpayer's cost of *A* shares as *Z* shares bear to entire *A* assets. *Mince & Co. v. Commissioner*, 24 B. T. A. 401 (1931); *Piedmont Financial Co. v. Commissioner*, 26 B. T. A. 1221 (1932).

³⁶ *Gregory v. Helvering*, *supra* note 32; J. L. Hand at 810.

³⁷ *Van Weise v. Commissioner*, 69 F. (2d) 439, 441 (C. C. A. 8th, 1934).

³⁸ *Bullen v. Wisconsin*, 240 U. S. 625, 630, 36 Sup. Ct. 473 (1916). "When the law draws a line, a case is on one side of it or the other, and if on the safe side is none the worse legally that a party has availed himself to the full of what the law permits."

³⁹ *United States v. Isham*, 87 U. S. 496, 506, 17 Wall. 496, 506 (1873). If the device is in legal form "it is subject to no legal censure." *Superior Oil Co. v. Mississippi*, 280 U. S. 390, 395, 50 Sup. Ct. 169 (1929). "You may intentionally go as close to it as you can if you do not pass it" (the line).

⁴⁰ *Iowa Bridge Co. v. Commissioner*, 39 F. (2d) 777 (C. C. A. 8th, 1930); *Jones v. Helvering*, 71 F. (2d) 214 (App. D. C. 1934).

⁴¹ *Altizer, Minimizing Federal Income Taxes* (1933) 39 W. VA. L. Q. 106. "A distinction is made between tax evasion, which implies concealment and is illegal, and tax avoidance, an open assertion of rights which is not only lawful but commanded by the dictates of good judgment * * *."

⁴² *Gregory v. Helvering*, *supra* note 32, at 811.

⁴³ *Gregory v. Helvering*, — U. S. —, 55 Sup. Ct. 266, 268 (1935).

⁴⁴ Cf. Senate Finance Committee, Rep. No. 398, 68th Cong., 1st Sess., Ser. No. 8220 (1924) 14. "The intention of the party at the time of the exchange is difficult to determine, is subject to change by him, and does not represent a fair basis of determining tax liability."

⁴⁵ *Hendricks, Taxation of Reorganizations* (1934) 34 COL. L. REV. 1198, 1208. "If the general proposition of making purpose decisive in every reorganization case had been presented to it Congress would have had to consider the vast administrative problems and the great uncertainty that would result from the enactment of any such rule."

⁴⁶ *Insurance & Title Guarantee Co. v. Commissioner*, *supra* note 6, at 844.

sulting from its inability to arrive at a working rule with regard to the problem of the corporate entity."⁴⁷ Although the statute does not appear to be in conformity with the ruling in this case it may be reconciled with a holding that "This section obviously has reference * * * to a transfer of its entire assets * * * or to a transfer of a part of the assets * * * that the corporation may thereafter be under one control and may be operated substantially as one *in the prosecution of his business*,"⁴⁸ and that assets to be exempt from gain must be acquired through a reorganization and not through liquidating proceedings,⁴⁹ and that reorganization "indicated readjustments of existing interests."⁵⁰ Again the court may have held in conformance with prior opinions that "earnings or profits of the original corporation remain for the purpose of distribution, earnings or profits of the successor in liquidation"⁵¹ and "tax exemptions are never lightly inferred."⁵²

Apparently the ruling in the *Gregory* case appeared too late to influence the Subcommittee of the Committee on Ways and Means in its drastic recommendation to repeal all of Section 112 of the Revenue Act in order to stay the tax evasions so prevalent under the existing reorganization definitions.⁵³ An opening attack on reorganization exemptions is to be found in the exclusion of Section 112 (g) from the Revenue Act of 1934—the clause under which *Gregory* claimed non-recognition of her gain.

IRVING DIAMOND.

OIL AND GAS—DEPLETION.—In the first law imposing a tax upon the net income of corporations there was contained a provision permitting a deduction from gross income for depreciation of property.¹ The act by its terms made no provision for a deduction from

⁴⁷ Finkelstein, *The Corporate Entity and the Income Tax* (1935) 44 YALE L. J. 436, 440. Discussion of the corporate entity in reorganizations.

⁴⁸ *Lonsdale v. Commissioner*, *supra* note 24, at 539. Italics our own.

⁴⁹ See *Ahles Realty Corp. v. Commissioner*, 71 F. (2d) 150 (C. C. A. 2d 1934). Petitioner, a new corporation, issued all of its stock and bonds for the old corporation's assets and the old corporation dissolved, leaving its sole stockholder in control of the petitioner. *Held*, that it was a reorganization as to petitioner who therefore did not acquire assets in liquidation proceedings.

⁵⁰ *Cortland Specialty Co. et al. v. Commissioner*, *supra* note 23, at 939.

⁵¹ *Commissioner v. Sansome*, 60 F. (2d) 931 (C. C. A. 2d, 1932), at 933.

⁵² *Heiner v. Colonial Trust Co.*, 275 U. S. 236, 237, 48 Sup. Ct. 80 (1927).

⁵³ Preliminary Report of the Subcommittee of the Committee on Ways and Means, 73d Cong., 2d Sess. (1934) 8, 9. Recommends "that the exchange and reorganization powers contained in Sec. 112 of existing law be abolished. * * * First it will close the door to one of the most prevalent methods of tax evasions."

¹ CORPORATION EXCISE LAW OF 1909, §38, 36 Stat. 112, 113. This act preceded the Sixteenth Amendment and was held to levy an excise tax, not an income tax. *Flint v. Stone Tracy Co.*, 220 U. S. 107, 31 Sup. Ct. 342 (1911); (1934) 9 ST. JOHN'S L. REV. 228.