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THE REORGANIZATION ALPHABET SOUP— FEDERAL TAX CONSEQUENCES*

G. Booker Ellis, Jr.**

Reorganization may be defined generally as the nontaxable exchange of stock, securities, or assets of a corporation principally for stock or securities of the acquiring corporation.¹

The tax law has a very basic principle on exchanges. Generally, gain or loss must be recognized where property is exchanged for property. The reorganization sections of the Internal Revenue Code provide an exception to this basic rule. Ordinarily, no gain or loss is recognized on a reorganization upon the theory that it is a mere paper transaction. Under a reorganization, any new corporate form normally does not disrupt previous participation in an enterprise. It does not change in substance the rights and relations of the parties to each other or to the corporate assets.

Reorganization provisions were first included in the Revenue Act of 1918.² The term *reorganization* was not defined under that Act. Subsequently, a definition was added.³ Then, very deliberately, Congress broadened the definition and provided related requirements. Many times these changes were the result of court decisions. The courts have had a great influence in the evolution of the present reorganization provisions.

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1. See Ellis, *The ABCs of Corporate Reorganizations*, 20 TAX EXECUTIVE 99 (1968), upon which portions of this article are based.

2. Revenue Act of 1918, § 202(b), ch. 18, 40 Stat. 1060. For a history of these provisions see R. HOLZMAN, CORPORATION REORGANIZATIONS, THEIR FEDERAL TAX STATUS, at 2.1 *et seq.* (1955).

3. Revenue Act of 1921, § 202(c)(2), ch. 136, 42 Stat. 230.

REORGANIZATIONS IN GENERAL

Types of Reorganizations. For federal income tax purposes, the term *reorganization* is defined in Section 368(a)(1) of the Internal Revenue Code. There are six classes of reorganizations, each being assigned a letter of the alphabet. This is a little alphabet of six letters.

Reorganizations include corporate acquisitions or transactions which fall into the following three general classes:

1. Acquisitive, where one corporation acquires another:
 - a. The A Type. Statutory mergers and consolidations.
 - b. The B Type. Acquisition by one corporation of stock control of another with the consideration being solely voting stock.
 - c. The C Type. Acquisition by one corporation of substantially all of the properties of another with the consideration usually being solely voting stock.
 - d. The acquisitive D Type. Acquisition by one corporation of substantially all of the assets of another as long as the transferor or its shareholders or any combination thereof controls the transferee. In addition, the transferor must be liquidated.
2. Divisive, where one corporation divides into two or more corporations:
 - a. The divisive D Type. Transfers of property by one corporation to another followed by a tax-free distribution of control of the transferee by the transferor.
3. Changes generally affecting one corporation:
 - a. The E Type. Recapitalization.
 - b. The F Type. Changes in identity, form, place or organization.⁴

Control has a special meaning for reorganization purposes. It is the ownership of 80 percent of the voting power of all classes of stock entitled to vote and at least 80 percent of the total number of each of the other classes of stock.⁵

Other Requirements. In addition to meeting the literal requirements of the Code, reorganizations must meet certain other tests. There must be a plan of reorganization and continuity of interest. Continuity of interest requires both continuity of busi-

4. It is possible that the F Type reorganization may involve more than one corporation. See the discussion of multiple F Type reorganizations below.

5. The classification of stock as voting or nonvoting and the meaning of control is discussed later.

ness and continuity of proprietary interest. In addition, there must be a business purpose.

Continuity of business means the surviving corporation must continue in business. Continuity of proprietary interest means a substantial portion of the consideration received by the transferor or its shareholders is stock the recipients intend to retain. The Revenue Service, for purposes of issuing letter rulings, requires that the value of this stock be at least 50 percent of the total consideration received.

All of these terms have special meanings. They will be considered in more detail later.

THE TAX CONSEQUENCES OF REORGANIZATIONS

Exchange of Stock or Securities for Stock or Securities. The acquisition by one corporation of stock or assets of another may qualify as a reorganization. In addition, the exchange by a corporation of its stock or securities for its own stock or securities or those of another corporation may also qualify. In these situations, exchanges pursuant to the plan of reorganization are accorded special treatment under the Internal Revenue Code. As a general rule, no gain or loss is recognized if stock or securities⁶ of a corporate party to a reorganization are exchanged under the plan solely for stock or securities in the same or another corporate party to the reorganization.⁷

An exception is provided where securities are involved and the principal sum of the securities received exceeds the principal sum of the securities surrendered, if any.⁸ If the principal amount of the securities received exceeds the amount of those exchanged, then the recipient recognizes gain. The amount of gain is the fair market value of the excess principal. The same rule applies to the fair market value of property received which is not stock or securities. The gain is sometimes referred to as boot. The gain is treated as a dividend to the extent the distribution has such an effect. Any additional gain is treated as capital gain.⁹ However,

6. The term securities is not defined in the Code or Regulations. The Revenue Service uses a rule of thumb that if a note, bond or other debt instrument matures over five years after its issuance, it is classified as a security. See *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). See also Rev. Rul. 59-98, 1959-1 CUM. BULL. 76, where the Revenue Service held bonds with an average life of six and one-half years were securities. It was stated consideration should be given to the time period and also to the degree of participation and continuing interest in the business. Under Treas. Reg. § 1.354-1(e) (1955), neither stock rights nor stock warrants are securities. See also Rev. Rul. 72-198, 1972 INT. REV. BULL. No. 17, at 29.

7. INT. REV. CODE of 1954, § 354(a)(1).

8. INT. REV. CODE of 1954, §§ 354(a)(2) and 356.

9. INT. REV. CODE of 1954, § 356. See also *Commissioner v. Estate of*

the sum of the dividend and the capital gain may not exceed the actual gain on the exchange.¹⁰

The basis of the stock or securities received by the distributees is the same as that of the property exchanged, adjusted for certain gains or losses recognized in the transaction.¹¹ Where other property is received, this may result in a decrease in the basis of the stock or securities.

The rules dealing with gain do not apply to B Type reorganizations. The B Type reorganization is an exchange of stock *solely* for voting stock and thus the boot provisions do not apply.

Exchange of Corporate Property for Stock or Securities. The Internal Revenue Code also provides, in general, that no gain or loss is recognized if a corporate party to a reorganization exchanges property, pursuant to a plan of reorganization. In general, the transferor must receive only stock or securities in another corporate party to the reorganization.¹² An exception applies in some cases where the transferor corporation receives money or property other than stock or securities in a C Type reorganization. If the transferor corporation distributes these assets to its

Bedford, 325 U.S. 283 (1945). With the above authorities, compare *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *rehearing denied*, 389 U.S. 893 (1967). The court held the portion of earnings and profits allocable to the shareholder included both those of the transferor and also the transferee in an F Type reorganization. The Revenue Service follows the *Davant* case where there is substantial identity of shareholders of both the transferor and the acquiring corporations. The Revenue Service view is that there is substantial identity only where the shareholders of the transferor own over 20 percent of the acquiring corporation. Rev. Proc. 69-6, § 3.01, 1969-1 CUM. BULL. 396. If the transferor corporation is a collapsible corporation under INT. REV. CODE of 1954, § 341, the gain which would otherwise be capital gain is treated as ordinary income. In Rev. Rul. 67-275, 1967-2 CUM. BULL. 142, the Revenue Service ruled on a situation where an acquiring corporation paid the cost of registering its stock with the Securities and Exchange Commission. Such a payment was not boot to the recipient of the stock.

10. INT. REV. CODE of 1954, § 356(a)(1). The informal position of the Revenue Service appears to be that the entire boot will qualify for capital gains treatment only if the shareholder meets the tests of INT. REV. CODE of 1954, § 302(b)(2), relating to substantially disproportionate redemptions of stock.

11. INT. REV. CODE of 1954, § 358. Generally, the carryforward basis to the distributee is decreased by the amount of money and fair market value of other boot received as well as any loss incurred on the exchange. It is increased for any amount treated as a dividend and the amount of any gain recognized on the exchange.

12. INT. REV. CODE of 1954, § 361. For purposes of an A or C Type reorganization, the assumption of a debt or transfer subject to a debt, even one in excess of basis, is disregarded if a special test is met. The assumption or transfer subject to debt must not be for either a tax avoidance purpose or a purpose which is not a bona fide business purpose. See INT. REV. CODE of 1954, § 357. In a D Type reorganization, the same rule applies except that gain is always recognized to the extent the total debt exceeds the total basis of the property transferred. INT. REV. CODE of 1954, § 357(c)(1).

shareholders, no gain is recognized.¹³ However, if the money or property is retained, gain is recognized. The gain is limited to the sum of the money and the fair market value of the other property received.¹⁴ A similar rule applies to a D Type reorganization. However, if in a D Type transaction the total debt assumed or to which the property is subject exceeds the total adjusted basis of the property transferred, gain may be recognized to the extent of the excess.¹⁵

If property is acquired by a corporation in a reorganization, its basis is the same as the basis in the hands of the transferor increased by any gain recognized by the transferor on the exchange.¹⁶

Illustration of Provisions. To illustrate, assume an individual, John, owns 100 shares of Transferor Corporation, which has been a profitable company. In addition, John holds 20-year bonds of Transferor having a face value of \$1,000 but a cost basis of \$900. Transferee Corporation acquires all of the assets of Transferor except its cash in a C Type reorganization, exchanging Transferee voting stock, Transferee securities, and some cash. In pursuance of the plan of reorganization, Transferor is completely liquidated. It distributes all its assets which consist of cash, Transferee voting stock and Transferee securities. Assume that John receives \$10 cash, 95 shares of Transferee voting stock and a 15-year Transferee debenture having a face value and a fair market value of \$1,100. Transferor recognizes no gain since the other property, consisting of cash received from Transferee, is distributed to Transferor shareholders. The basis of the Transferor assets remains unchanged in the hands of Transferee. John recognizes gain not in excess of \$110. The maximum gain recognized is the sum of the \$10 cash and \$100 fair market value of the excess of the principal amount of the Transferee debenture received over the Transferor bond surrendered. Assume further that the entire gain is taxable. It is treated as dividend income to the extent of John's share of the accumulated earnings and profits of Transferor. The balance of the gain is capital gain.¹⁷ The basis to John of the Transferee debenture received is \$1,000. It is the sum of the basis of the Transferor

13. INT. REV. CODE of 1954, § 361(b)(1)(B).

14. INT. REV. CODE of 1954, § 361(b)(1)(A).

15. INT. REV. CODE of 1954, § 357(c)(1)(B).

16. INT. REV. CODE of 1954, § 362(b). The gain must be recognized by the transferor to obtain an increase in basis. Gain recognized by the shareholders of the transferor has no effect on basis of assets of the transferor in the hands of the transferee.

17. This is true assuming Transferor is not a collapsible corporation within the meaning of INT. REV. CODE of 1954, § 341. See note 9 *supra*.

bond of \$900 and the \$100 fair market value of the increased principal of the Transferee debenture over the Transferor bond. The basis to John of the Transferee stock remains unchanged since it is decreased by the boot received attributable to the stock, or \$10, and increased by a like amount since it was treated as a dividend.¹⁸

REASONS FOR A REORGANIZATION

Tax Reasons. Whether an acquisition qualifies as a reorganization sometimes is of more concern to the transferor corporation and its shareholders. In a taxable acquisition, the basis of the property acquired is the fair market value of the consideration.¹⁹ However, in some cases the acquiring corporation may want certain corporate tax attributes of the transferor. For example, assume that Transferor Corporation has some high basis depreciable assets. Assume further that Transferee Corporation wishes to acquire the entire assets of Transferor principally for business reasons. In this instance, Transferee Corporation might want a nontaxable acquisition so that the tax basis of the Transferor assets will remain unchanged. The availability of the corporate tax attributes of a predecessor company is discussed below in more detail.

Accounting Reasons. Another reason for arranging a corporate acquisition in a particular manner may be the accounting treatment for financial purposes. The Accounting Principles Board of the American Institute of Certified Public Accountants has issued Opinions 16 and 17.²⁰ Opinion 16 deals with the classification of an acquisition as a pooling of interest or as a purchase. Opinion 17 deals with the requirement to amortize goodwill. A review of these Opinions is beyond the scope of this discussion. However, many tax reorganizations may be classed as purchases for financial purposes.²¹ In some instances, a purchase for tax purposes may be classed as a pooling of interest for financial purposes.²² These Opinions may have a significant

18. Treas. Reg. § 1.358-2 (1955).

19. INT. REV. CODE of 1954, § 1012.

20. A.P.B. Opinion No. 16, Business Combinations, August, 1970; A.P.B. Opinion No. 17, Intangible Assets, August, 1970.

21. See para. 47b of A.P.B. Opinion No. 16, Business Combinations, August, 1970, which, in general, requires the use of voting common stock to qualify as a pooling of interest. Thus, many times a tax reorganization will not qualify as a pooling of interest.

22. Under para. 47b of A.P.B. Opinion No. 16, Business Combinations, August, 1970, a corporation might use cash in purchasing all of the stock held by a 10 percent shareholder and acquire the balance of the stock for its voting stock. The transaction should be accounted for as a pooling of interest. However, it would not qualify as a B Type reorganization since solely voting stock is

effect upon the financial earnings of the acquiring company. In many instances the financial treatment may dictate the form of acquisition. As such, it might be more attractive to the acquiring corporation to arrange a transaction as a tax-free reorganization.

THE A TYPE

Qualification. The A Type is a statutory merger or consolidation. To qualify, there must be strict conformity with the applicable corporate law.²³ Merger and consolidation are not synonymous. Under a merger, one of the old entities remains in existence.²⁴ In a consolidation, the predecessor corporations transfer their assets to a newly created entity.²⁵ In both instances, shareholders and creditors of the predecessors become shareholders and creditors of the survivor by operation of law.²⁶

Consideration—In General. The A Type is an acquisitive reorganization where consideration other than voting stock may be used readily. As a result, the A Type is fraught with perils. Continuity of proprietary interest requires a balance between stock and nonproprietary consideration. For ruling purposes, the Revenue Service requires that the shareholders of the transferor receive a certain proportion of the consideration in stock. This stock must be that of the transferee or, in some cases, a corporation controlling the transferee or the transferor. The value of the stock must be at least 50 percent of the value of all the formerly outstanding stock of the acquired or transferor corporation.²⁷ However, the Court of Appeals for the Sixth Circuit was satisfied with substantially less than this. It held the continuity of interest requirement was satisfied when only 25 percent of the consideration was stock of the acquiring corporation.²⁸ Continuity of proprietary interest is discussed in more detail below.

Consideration—Stock of Corporation Controlling Acquiring Corporation. A special provision was enacted in 1968 dealing with statutory mergers.²⁹ Under this provision, one corporation

required. The acquired corporation might be liquidated under INT. REV. CODE OF 1954, § 334(b)(2). As such, the cost of the stock, with some adjustments, would be the basis of the assets for income tax purposes.

23. Treas. Reg. § 1.368-2(b) (1955).

24. See, e.g., CAL. CORP. CODE § 4101 (West 1955).

25. *Id.*

26. *Id.*

27. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, modified on other issues in Rev. Proc. 67-13, 1967-1 CUM. BULL. 590, Rev. Proc. 68-32, 1968-2 CUM. BULL. 918, and Rev. Proc. 69-6, 1969-1 CUM. BULL. 396.

28. Miller v. Commissioner, 84 F.2d 415 (6th Cir. 1936). See also Miller v. Commissioner, 103 F.2d 58 (6th Cir. 1939).

29. Act of Oct. 22, 1968, Pub. L. No. 90-621, 82 Stat. 1310, 1968-2 CUM.

may be merged into another and the consideration may be stock of a corporation controlling the acquiring corporation.³⁰ However, certain conditions must be met. The acquiring corporation must obtain substantially all of the properties of the transferor.³¹ In addition, none of the stock of the acquiring corporation may be used in the transaction.³² Finally, the acquisition must be one that would have qualified as an A Type reorganization had the merger been into the controlling parent corporation.³³ By virtue of this amendment, stock of a parent corporation controlling the acquiring corporation may be used in an A Type acquisition, as is the case in both B and C Type acquisitions. The informal position of the Revenue Service is that nonvoting stock as well as boot may be used in the acquisition.

Consideration—Stock of Corporation Controlling Acquired Corporation. Another provision dealing with A Type acquisitions was enacted effective after 1970.³⁴ It deals with the so-called *reverse merger*. Stock of a corporation controlling the acquired corporation may be transferred to shareholders of the transferee for their transferee stock. As long as the other requirements of a merger are met, the transaction will qualify as an A Type if two additional conditions are met. The first is that the surviving corporation must hold substantially all of its properties and those of the merged corporation except stock of the control-

BULL. 769, which added INT. REV. CODE of 1954, § 368(a)(2)(D). It is effective for mergers occurring after October 22, 1968.

30. The Senate Finance Committee Report indicates when the provision applies. It is stated that it applies "whether or not the parent corporation is formed immediately before the merger, in anticipation of the merger, or after preliminary steps were taken to merge directly." S. Rep. No. 1653, 90th Cong., 2d Sess. (1968), 1968-2 CUM. BULL. 849, at 851.

31. Proposed Treas. Reg. § 1.368-2(b)(2), 37 Fed. Reg. 7162 (1972), provides that the term *substantially all* has the same meaning under this provision as in the case of C Type acquisitions. The Revenue Service ruling position for purposes of C Type reorganizations is that substantially all is satisfied if two tests are met. The properties must equal in value 70 percent of the fair market value of the gross assets of the transferor. In addition, they must equal in value 90 percent of the fair market value of the net assets of the transferor. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, Sec. 3, which was modified on other issues as indicated in note 27 *supra*. The meaning of *substantially all* under a C Type acquisition is discussed later in more detail.

32. INT. REV. CODE of 1954, § 368(a)(2)(D).

33. INT. REV. CODE of 1954, § 368(a)(2)(D). Proposed Treas. Reg. § 1.368-2(b)(2), 37 Fed. Reg. 7162 (1972), provides that under this test it is irrelevant whether the hypothetical merger into the parent was impossible under state or federal corporate law. The Senate Finance Committee Report indicates the only requirement is that a merger into the parent would have been an A Type "insofar as the tax laws are concerned." S. Rep. No. 1653, 90th Cong., 2d Sess. (1968), 1968-2 CUM. BULL. 849, at 851.

34. Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077, added INT. REV. CODE of 1954, § 368(a)(2)(E). It applies to statutory mergers occurring after December 31, 1970.

ling corporation distributed in the transaction.³⁵ The second condition is that the former shareholders of the surviving corporation must surrender, for voting stock of the controlling corporation, control of the survivor.³⁶ In other words, voting stock of the controlling corporation must be exchanged for control of the surviving corporation. This last requirement is somewhat unique in A Type reorganizations.

Transfer to Subsidiary. Under Section 368(a)(2)(C) of the Internal Revenue Code, a corporation might be merged into a parent corporation in an A Type acquisition followed by a transfer of part or all of these assets to a corporation it controls.³⁷

Shareholder Approval. The merger or consolidation route normally requires shareholder approval for all corporations directly involved. Under some circumstances, this is a very serious burden. For example, in California, a statutory merger or consolidation requires the affirmative vote of two-thirds of the issued and outstanding shares of each class, regardless of any limitations or restrictions on the voting power.³⁸ Additionally, in California,

35. The informal position of the Revenue Service is that *substantially all the properties* has the same meaning here as in the case of a C Type acquisition. See note 31 *supra*. The Committee Reports on the Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077, make it clear that the provision applies whether or not the merged corporation has substantial properties. The merged corporation need not hold assets other than the nominal capital required to organize it and stock of its parent which is distributed in the exchange. See 3 CCH 1972 STAND. FED. TAX REP. ¶ 2549.01 and 3 P-H 1972 FED. TAX SERV. ¶ 18,325.5.

36. Under INT. REV. CODE of 1954, § 368(c), control is 80 percent of the voting power of all classes of stock entitled to vote and 80 percent of each other class of stock. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115. The Committee Reports on the Act of Jan. 12, 1971, Pub. L. No. 91-693, 84 Stat. 2077, make it clear that if control of the survivor is exchanged for voting stock of the controlling corporation, there is no restriction on any additional consideration. See 3 CCH 1972 STAND. FED. TAX REP. ¶ 2549.01 and 3 P-H 1972 FED. TAX SERV. ¶ 18,325.5. For example, where all of the stock of the surviving corporation is acquired, the consideration may be 80 percent voting stock and 20 percent cash.

37. See Rev. Rul. 68-261, 1968-1 CUM. BULL. 147, where, after an A Type reorganization, the acquired properties were transferred to six wholly owned subsidiaries. This was held not to invalidate the acquisition since Treas. Reg. § 1.368-2(h) (1955) provides, for purposes of INT. REV. CODE of 1954, § 368, the singular includes the plural if the context so requires.

38. CAL. CORP. CODE § 4107 (West 1955). In B and C Type acquisitions, approval by shareholders of the acquiring corporation is not ordinarily required. However, the New York Stock Exchange has a special rule that may require such approval in some B and C Type acquisitions. See NEW YORK STOCK EXCHANGE COMPANY MANUAL A284 (1968). In general, approval of shareholders of the acquiring corporation is required in the following instances:

- a. Directors, officers, or substantial security holders of the acquiring corporation hold an interest in the transferor.
- b. Issuance by the acquiring corporation of common stock or securities convertible into common stock might increase the outstanding common shares by 20 percent or more, and

dissenting shareholders of the acquired or transferor corporation may require the purchase of their shares.³⁹ For these reasons, the merger or consolidation, or A Type, many times may be bypassed in favor of other somewhat less restrictive reorganizations. Recent amendments to the Code covering situations where stock of a corporation controlling either the acquired or acquiring corporation may be used have done much to alleviate this difficulty.

THE B TYPE

Qualification and Consideration. The B Type acquisition is one where, generally speaking, one corporation obtains control of another *solely* for voting stock.⁴⁰ Control is 80 percent of the voting power of all classes of stock entitled to vote and at least 80 percent of the total number of all other classes of stock.⁴¹ At one time, only voting stock of the acquiring corporation might be used. However, the Revenue Act of 1964 equated the treatment of the B Type reorganization with that of the C Type. It provided that stock of a corporation controlling the acquiring corporation qualified as consideration in a B Type acquisition.⁴² The 1954 Code, as enacted August 16, 1954, contained such a provision with respect to a C Type reorganization.⁴³ Thus, as a

c. The stock or securities described under b, above, have a value approximately 20 percent or more of the value of the outstanding common stock.

The American Stock Exchange has a similar rule. See AMERICAN STOCK EXCHANGE COMPANY GUIDE § 713 (1968).

39. CAL. CORP. CODE § 4300 (West 1955). Such a provision may make it difficult to meet the continuity of interest test. An example might be where substantially all the dissenting one-third made such a demand and the two-thirds approving the merger receive both stock and other consideration. See Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

40. INT. REV. CODE OF 1954, § 368(a)(1)(B). An interesting B Type acquisition was involved in Rev. Rul. 67-448, 1967-2 CUM. BULL. 144. A parent corporation formed a new corporation contributing parent voting stock to it. The new corporation merged into an unrelated corporation with the parent obtaining control. The Revenue Service ruled this was a B Type acquisition. In Rev. Rul. 68-435, 1968-2 CUM. BULL. 155, there was a delay in closing a B Type exchange. The acquiring corporation paid the transferors the quarterly dividend they would have received had the transaction not been delayed. The Revenue Service ruled this did not adversely affect the B Type acquisition. See also Rev. Rul. 69-443, 1969-2 CUM. BULL. 54. Approval by shareholders of the acquiring corporation in a B Type acquisition is not ordinarily necessary. However, see footnote 38 *supra* for a discussion of the rules of the New York and American Stock Exchanges applying to some B Type transactions.

41. INT. REV. CODE OF 1954, § 368(c). The Revenue Service requires that 80 percent of each class of nonvoting stock be acquired. Rev. Rul. 59-259, 1959-2 CUM. BULL. 115. The definition of voting stock is discussed later.

42. INT. REV. CODE OF 1954, § 368(a)(1)(B), as amended by Revenue Act of 1964, § 218, Pub. L. 88-272, 78 Stat. 57.

43. INT. REV. CODE OF 1954, § 368(a)(1)(C). See also S. Rep. No. 1622, 83rd Cong., 2d Sess. 273 (1954), dealing with this portion of H.R. 8300, which became the Internal Revenue Code of 1954.

result of the 1964 amendment, the acquiring corporation in a B Type acquisition may use voting stock of its parent as long as the parent controls the acquiring corporation. Reference is made in the statute to the alternative of transferring stock of the parent. Thus, in all likelihood, a combination of voting stock of the acquiring corporation and its parent would not qualify as a B Type reorganization. The Proposed Regulations take this position.⁴⁴

In order for an acquisition to be solely for voting stock, preferred or common, it appears essential that the acquiring corporation not pay any obligations of the shareholders of the acquired corporation. Examples would include expenses arising from the reorganization, such as fees of accountants, attorneys, underwriters and similar items.⁴⁵

Transfer to Subsidiary. It is also permissible in a B Type acquisition for the acquiring corporation to transfer part or all of the acquired stock to a corporation controlled by the acquiring corporation.⁴⁶ For example, assume an acquiring corporation issues its voting stock in exchange for 80 percent of the stock of a transferor and then assigns the transferor stock to its controlled subsidiary. The transaction still qualifies as a B Type reorganization.

Fractional Shares. At one time, the Revenue Service took the view that the entire consideration had to be voting stock. Under this view, the presence of any other consideration, however small, would prevent an acquisition from being classified as a B Type reorganization. The basis for this rule was a statement by the Supreme Court that the word *solely*, as used in the statute, leaves no leeway.⁴⁷ Thus, if cash, evidences of indebtedness, or non-voting stock are used in an acquisition, it will not qualify as a B Type reorganization. In some acquisitions, cash is used in lieu of fractional shares. The Revenue Service formerly would not issue rulings that transactions involving such minor cash payments qualified as B Type reorganizations. The position was taken that such acquisitions were fully taxable to shareholders

44. Proposed Treas. Reg. Sec. 1.368-2(c), 37 Fed. Reg. 7162 (1972).

45. To obtain a favorable ruling from the Revenue Service, it must be represented that the acquiring corporation will not pay or assume any obligations of the acquired corporation or its shareholders for certain expenses. They are expenses arising from the acquisition. It must be represented that the acquiring corporation will pay only its own expenses. See *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942), *rehearing denied*, 315 U.S. 829 (1942), *second petition for rehearing denied*, 316 U.S. 710 (1942). See note 71 *infra* for the view expressed in other cases dealing with C Type acquisitions.

46. INT. REV. CODE of 1954, § 368(a)(2)(C).

47. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942), *rehearing denied*, 315 U.S. 829 (1942), *second petition for rehearing denied*, 316 U.S. 710 (1942).

of the acquired corporation. In 1964, the Court of Appeals for the Fifth Circuit decided *Mills v. Commissioner*.⁴⁸ In that case, the acquisition agreement contained a provision that if the value of three corporations to be acquired, as determined by audit, was not evenly divisible, the difference would be paid in cash. A transferor received \$27.36 in lieu of fractional shares. The Revenue Service contended that the cash made the acquisition fully taxable. The Tax Court sustained the Revenue Service. Upon appeal, the Court of Appeals for the Fifth Circuit reversed. The effect of this decision is that, while there cannot be any consideration other than voting stock in a B Type acquisition, a mathematical rounding off for fractional shares does not in reality constitute consideration. Faced with this decision, the Revenue Service has now reversed its earlier position. Now it will issue favorable rulings where cash is paid in lieu of fractional shares as long as both of the following conditions are met:

1. Cash is not an independent part of the consideration, and
2. The facts demonstrate that the cash payment is merely a mechanical rounding off process and not the result of bargaining.⁴⁹

Control. There cannot be a B Type reorganization unless the acquiring corporation has *control* of the transferor following the exchange. Control requires the holding of 80 percent of the total voting power of all classes of stock entitled to vote and 80 percent of the total number of shares of all other classes of stock.⁵⁰

The Regulations provide that control may be achieved through a series of stock for stock exchanges over a short period of time, such as 12 months.⁵¹ However, it would appear that the key issue is not the length of time to consummate the acquisition of control. Instead, it should be whether the exchanges are pursuant to a single plan of reorganization.⁵² The primary require-

48. *Mills v. Commissioner*, 331 F.2d 321 (5th Cir. 1964), *rev'g* 39 T.C. 393 (1962).

49. Rev. Rul. 66-365, 1966-2 CUM. BULL. 116. Cash payments qualifying under these tests are treated as being paid to the shareholders in redemption of the fractional share interest.

50. INT. REV. CODE of 1954, § 368(c). In Rev. Rul. 59-259, 1959-2 CUM. BULL. 115, the Revenue Service construed 80 percent of the total number of all classes of nonvoting stock as 80 percent of the total number of each class. Under Rev. Rul. 56-613, 1956-2 CUM. BULL. 212, a single corporation must have control.

51. Treas. Reg. § 1.368-2(c) (1955). See also Proposed Treas. Reg. § 1.368-2(c), 37 Fed. Reg. 7162 (1972).

52. See *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3rd Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). The Court

ment for qualification of such a series of exchanges as one acquisition is that they represent steps pursuant to a plan of reorganization whereby the final step results in the 80 percent control.

The acquisition of additional blocks of stock may qualify as a B Type reorganization where 80 percent of the stock already is owned, regardless of how the 80 percent interest was acquired. It is the existence of control after the exchange that qualifies the transaction, rather than the acquisition of control in a single transaction.⁵³

If the acquiring corporation already owns stock of the transferor corporation acquired prior to the conception of a plan for reorganization, even over 20 percent, this will not in and of itself disqualify subsequent acquisitions. Assume that Transferee Corporation purchased 25 percent of the only class of stock of Transferor Corporation for cash in 1960 for investment purposes without consideration of additional acquisitions. Assume further that on February 1, 1972, Transferee offers, pursuant to a plan of reorganization, to exchange its own voting stock for at least 60 percent of Transferor if accepted within six months. If Transferee completes the 60 percent acquisition, it will own 85 percent of the Transferor stock and will control Transferor. No gain or loss is recognized on the exchanges since it results in a B Type reorganization.⁵⁴ However, if the original stock was acquired for consideration other than voting stock, the subsequent acquisition might be taxable had Transferee formulated a plan originally for the subsequent acquisition of 80 percent of Transferor. The reasoning is that if, under the step transaction doctrine, the two transactions are viewed as one, the consideration would not be solely voting stock. As a consequence, it would not qualify as a B Type reorganization. This conclusion would remain true even though control of the acquired corporation exists without considering the stock acquired for other than voting stock.⁵⁵

held that, if a series of transactions are so mutually interdependent that one step would be fruitless without the completion of the series, the whole series is viewed as a single transaction. However, the Court of Claims in *American Potash & Chemical Corp. v. U.S.*, 399 F.2d 194 (Ct. Cl. 1968), *on rehearing*, 402 F. 2d 1000 (Ct. Cl. 1968), discussed the 12 month rule. It indicated that the 12 month period is controlling unless it is shown that all acquisitions over a longer period were part of a continuing offer to acquire.

53. Under INT. REV. CODE of 1939, § 112(g)(1)(B), it was doubtful if a transaction qualified as a B Type reorganization unless the 80 percent control was acquired for voting stock in a single transaction. A problem might arise, for example, where the acquiring corporation owned over 20 percent before the acquisition. *See* S. Rep. No. 1622, 83rd Cong. 2d Sess. 273 (1954).

54. *See* the example in Treas. Reg. § 1.368-2(c) (1955) and Proposed Treas. Reg. § 1.368-2(c), 37 Fed. Reg. 7162 (1972).

55. *Lutkins v. United States*, 312 F.2d 803 (Ct. Cl. 1963), *cert. denied*, 375

In 1972, the Revenue Service announced a limitation on this principle. Assume Transferor Corporation purchased stock of Transferee Corporation for cash. If Transferor sells this stock to an unrelated third party, then Transferor may acquire Transferee in a subsequent B Type acquisition if the unrelated third party was under no obligation to transfer his stock. The fact that the sale was made to the third party only to qualify the subsequent B Type acquisition has no adverse effect on the B Type reorganization.⁵⁶

Redemption or Distribution Prior to Acquisition. Assume prior to an acquisition the transferor corporation redeems part of its stock by a distribution of assets. It appears the Revenue Service views such a distribution as having no adverse effect upon a subsequent B Type acquisition. The Revenue Service has ruled that a B Type reorganization was not adversely affected where the acquired corporation redeemed its preferred stock before the acquisition.⁵⁷ The Revenue Service has also ruled that a distribution of property to a shareholder immediately before the exchange will not adversely affect a B Type transaction.⁵⁸ The Revenue Service position appears to be that, even though a redemption might be part of an overall plan, the 80 percent control test is applied to outstanding stock after the redemption. The rationale of this ruling might also cover a transfer by the acquired corporation of its assets prior to the acquisition such as by dividend or sale. See the discussion below under C Type reorganizations.

B Type as a C Type. The Revenue Service considered a situation where, after a purported B Type acquisition, the acquired corporation was liquidated. The Service ruled that the transaction was, in substance, a C Type reorganization.⁵⁹ There were two steps consisting of the acquisition and the liquidation. They were considered part of a single plan and were not treated separately for tax purposes.

U.S. 825 (1963); *Howard v. Commissioner*, 238 F.2d 943 (7th Cir. 1956). In the *Howard* case, over 80 percent of the stock was acquired solely for voting stock of the acquiring corporation and additional shares were acquired for cash. Each shareholder of the acquired corporation received only stock or cash, with one exception. See also *Turnbow v. Commissioner*, 368 U.S. 337 (1961).

56. Rev. Rul. 72-354, 1972 INT. REV. BULL. No. 29, at 4.

57. Rev. Rul. 55-440, 1955-2 CUM. BULL. 226. See also Rev. Rul. 68-285, 1968-1 CUM. BULL. 147. However, in Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, it is stated that sales, redemptions and other dispositions of stock pursuant to the plan are considered in determining if there is continuity of proprietary interest. Rev. Proc. 66-34 was modified on other issues as indicated in note 27 *supra*.

58. Rev. Rul. 70-172, 1970-1 CUM. BULL. 77.

59. Rev. Rul. 67-274, 1967-2 CUM. BULL. 141. This ruling represents an excellent illustration of the step transaction doctrine. See note 52 *supra*.

THE C TYPE

Qualification. The C Type acquisition is one where substantially all of the properties of one corporation are acquired by another. The consideration normally must be solely voting stock of the acquiring corporation.⁶⁰ There are three exceptions to the voting stock requirement:

1. As in the case of certain A and B Type reorganizations, the exchange may be for voting stock of the parent controlling the acquiring corporation.⁶¹
2. Debt of the transferor corporation may be assumed by the acquiring corporation or the properties of the transferor may be assigned subject to the debt.⁶²
3. A seldom applicable provision allows some consideration other than voting stock under very restricted circumstances.⁶³

Reference is made in the statute to the alternative of transferring voting stock of the parent. A combination of voting stock of the acquiring corporation and voting stock of the parent controlling it will not qualify as a C Type reorganization.⁶⁴ There is no requirement in a C Type acquisition that the transferor be liquidated.⁶⁵

Assumption of Liabilities. The statute provides that liabilities of the transferor corporation may be assumed or that its properties may be transferred subject to such liabilities without dis-

60. INT. REV. CODE of 1954, § 368(a)(1)(C). The C Type was referred to as a *practical merger* in Rev. Rul. 56-345, 1956-2 CUM. BULL. 206. Approval by shareholders of the acquiring corporation in a C Type acquisition is not ordinarily necessary. However, see note 38 *supra* for a discussion of the rules of the New York and American stock exchanges applying to some C Type transactions.

61. INT. REV. CODE of 1954, § 368(a)(1)(C). The meaning of control has been considered above under B Type reorganizations.

62. INT. REV. CODE of 1954, § 368(a)(1)(C). This provision had its genesis in Section 213(a) of the Revenue Bill of 1939 which was enacted to legislatively overrule *United States v. Hendler*, 303 U.S. 564 (1938), *rehearing denied*, 304 U.S. 588 (1938). The *Hendler* case held, in effect, that the assumption of liabilities and their subsequent payment constituted consideration other than stock. See H.R. Rep. No. 855, 76th Cong., 1st Sess. (1939), 1939-2 CUM. BULL. 504, at 518 *et seq.* and S. Rep. No. 648, 76th Cong., 1st Sess. (1939), 1939-2 CUM. BULL. 524, at 525.

63. INT. REV. CODE of 1954, § 368(a)(2)(B).

64. Treas. Reg. § 1.368-2(d)(1) (1955).

65. Cf. INT. REV. CODE of 1954, § 354(b)(1)(B), where there is such a requirement in the case of an acquisitive D Type reorganization. In Rev. Rul. 68-358, 1968-2 CUM. BULL. 156, the Revenue Service approved a transaction where the transferor in a C Type reorganization remained in existence solely to hold the stock of the transferee. See also *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); and *Stockman Nat'l Life Ins. Co. v. U.S.*, 336 F. Supp. 1202 (D. S.D. 1971).

qualifying the acquisition. However, the Revenue Service has contended that certain types of debt assumption result in consideration other than voting stock. Such arguments have sometimes been advanced where the acquiring corporation substitutes its own instruments of indebtedness for those originally issued by the transferor.⁶⁶ They are also advanced where the acquiring corporation satisfies liabilities of the transferor arising out of the reorganization.⁶⁷

The litigation dealing with the substitution of indebtedness of the acquiring corporation has not been too extensive. However, it seems established that, where the principal amount of the substituted indebtedness of the acquiring corporation is the same, there is an assumption within the meaning of the statute. This appears true even though the maturity date, interest rate, and character of convertibility change.⁶⁸ On the other hand, where the acquiring corporation substituted its secured indebtedness in place of the unsecured debt of the transferor, it was held that there was no assumption of a liability.⁶⁹

*Helvering v. Southwest Consolidated Corp.*⁷⁰ is the leading case dealing with liabilities arising out of a reorganization. The Supreme Court held that, where an acquiring corporation assumed a liability to pay off dissenting bondholders, this was consideration other than voting stock. The assumption of these liabilities, in substance, constitutes the borrowing of funds by the acquiring corporation and their payment to the transferor corporation to apply on the debt.

The Revenue Service does not view expenses arising out of the reorganization, such as fees of accountants, attorneys, underwriters and like items, as liabilities under the statute.⁷¹ Accordingly, under this view, the assumption of these liabilities by the

66. *Helvering v. Taylor*, 128 F.2d 885 (2d Cir. 1942), *aff'g* 43 B.T.A. 563 (1941).

67. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942), *rehearing denied*, 315 U.S. 829 (1942), *second petition for rehearing denied*, 316 U.S. 710 (1942).

68. *Helvering v. Taylor*, 128 F.2d 885 (2d Cir. 1942), *aff'g* 43 B.T.A. 563 (1941). *See also* *New Jersey Mortgage & Title Co.*, 3 T.C. 1277 (1944), *acquiesced in*, 1945 CUM. BULL. 5.

69. *Stoddard, Jr. v. Commissioner*, 141 F.2d 76 (2d Cir. 1944), *modified on another issue*, 152 F.2d 445 (2d Cir. 1945).

70. 315 U.S. 194 (1942), *rehearing denied*, 315 U.S. 829 (1942), *second petition for rehearing denied*, 316 U.S. 710 (1942).

71. *See note 45 supra*. It seems doubtful if the courts would adopt such a position, however. The Tax Court has held the assumption and payment of such expenses does not disqualify a C Type reorganization. *Claridge Apartments Co.*, 1 T.C. 163 (1942), *acquiesced in*, 1943 CUM. BULL. 4, *rev'd on other issues*, 323 U.S. 141 (1944); *Alcazar Hotel, Inc.*, 1 T.C. 872 (1943), *acquiesced in*, 1947-1 CUM. BULL. 1, *appeal dismissed* (6th Cir. 1945).

acquiring corporation would constitute consideration other than voting stock. One alternative is for the transferor corporation to retain sufficient liquid assets to discharge these expenses and also its obligation to any dissenting shareholders or bondholders. However, such a retention could affect the *substantially all of the properties* test. The Revenue Service ruling policy in C Type reorganizations is that the properties transferred must meet certain criteria. The value of the properties transferred must be 90 percent or more of the fair market value of the net assets. In addition, this value must be 70 percent or more of the fair market value of all the corporate assets held by the transferor immediately before the transfer.⁷² The *substantially all of the properties* requirement is discussed in more detail below.

Consideration Other Than Voting Stock. Section 368(a)(2)(B) of the Internal Revenue Code provides a limited exception to the solely for voting stock requirement. In very restricted situations, some consideration other than voting stock may be used without disqualifying a C Type reorganization. The exception applies only where three conditions are met:

1. The acquiring corporation receives substantially all of the properties of the transferor.
2. Some of the consideration is money or property other than voting stock of the acquiring corporation. Liabilities of the transferor are considered property other than voting stock for this purpose.
3. At least 80 percent of the properties of the transferor are acquired solely for voting stock.⁷³

Thus, if the sum of the liabilities of the transferor and the consideration other than voting stock exceeds 20 percent of the value of the total properties of the transferor, the transaction will not qualify. The liabilities of the transferor include those assumed by the transferee and those to which the properties are subject. It would be unusual for this special exception to apply to an ordinary trading or manufacturing corporation. In almost all cases, the liabilities of such a corporation will exceed 20 percent of the value of its total properties. If the transaction does not qualify under the 20 percent rule, only voting stock may be used and the transferor should pay or make provision for its reorganization expenses. Otherwise, the acquisition may not qualify as a C Type reorganization. In the usual case, the transferor will retain cash or other liquid assets to discharge its reorganization expenses.

72. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

73. INT. REV. CODE OF 1954, § 368(a)(2)(B).

If a corporation purchases part of the stock of a corporation to be acquired and then exchanges its voting stock for all of the properties of the transferor, the Revenue Service views the two transactions as a single one. The net effect is that the acquiring corporation has received some properties for its voting stock and the remainder in liquidation of its position as a shareholder. This might and frequently will convert the acquisition into a taxable transaction.⁷⁴

In determining whether substantially all of the corporate properties are transferred, the Revenue Service applies a special test for ruling purposes. The value of the properties retained may not exceed ten percent of the fair market value of the net assets of the transferor. In addition, the value of the retained properties may not exceed 30 percent of the fair market value of the gross assets of the transferor. Both of these tests are applied immediately before the transfer.⁷⁵ This is discussed in more detail below.

In cases where the special exception is relied upon, contingent or undisclosed liabilities may surprise the tax planner. If these liabilities eventually become more substantial than originally estimated, the 20 percent test might not be satisfied. In such a case, the transaction might be taxable. The reasonableness of estimates on the acquisition date appears completely immaterial. The applicability of the exception seems to depend upon the actual amount of the liabilities on the acquisition date, not estimates.

Fractional Shares. The same rule regarding fractional shares prevails as in the case of B Type reorganizations.⁷⁶

Transfer to Subsidiary. As in the case of the A and B Type reorganizations,⁷⁷ the transfer of all or part of the acquired assets to a controlled subsidiary will not disqualify a C Type reorganization.⁷⁸

74. *Bausch & Lomb Optical Co. v. Commissioner*, 267 F.2d 75 (2d Cir. 1959), *cert. denied*, 361 U.S. 835 (1959). In such a case, the acquisition is not solely for voting stock. See also Rev. Rul. 54-396, 1954-2 CUM. BULL. 147. In Rev. Rul. 57-278, 1957-1 CUM. BULL. 124, a parent corporation owned 72 percent of the corporation to be acquired. A new corporation was formed with the parent transferring its voting stock to it. Then the new corporation acquired all of the properties of the 72 percent owned subsidiary solely for the voting stock of its parent. The Revenue Service ruled that this was a C Type reorganization. This is one way in which the impact of the *Bausch & Lomb* decision might be avoided. Compare Rev. Rul. 69-48, 1969-1 CUM. BULL. 106. Another way to avoid the impact of this decision might be by an A Type reorganization. See Rev. Rul. 58-93, 1958-1 CUM. BULL. 188.

75. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

76. Rev. Rul. 66-365, 1966-2 CUM. BULL. 116.

77. See text accompanying notes 37 and 46 *supra*.

78. INT. REV. CODE of 1954, § 368(a)(2)(C). See also Rev. Rul. 64-73,

Substantially All of the Properties of the Transferor. This phrase has no statutory definition. The courts and the Revenue Service have sometimes used different approaches and theories in determining when the *substantially all of the properties* test is met. Under the total properties theory, the test is applied to the value of the total corporate properties. Under the operating properties theory the test is applied only to the corporate operating properties.

In 1966 the Revenue Service issued a Revenue Procedure dealing with this problem.⁷⁹ It was stated that for ruling purposes a definite standard should apply to C Type transactions. To constitute substantially all of the properties, two conditions must be satisfied. The value of the assets transferred must be at least 90 percent of the fair market value of the net assets of the transferor. In addition, the value of the transferred assets must be at least 70 percent of the fair market value of the gross assets of the transferor.⁸⁰ However, the Service stated that this operating rule was not intended to define the phrase *substantially all of the properties* as a matter of law.⁸¹ In an early case the Court of Appeals for the Ninth Circuit appeared to reject the operating properties theory. It held that a transfer of all of the operating properties was not necessarily substantially all the properties.⁸²

The operating properties theory seems to have the support of the great weight of tax authority. In 1957, the Revenue Service ruled that the meaning of substantially all of the properties in C Type acquisitions depends upon the facts and circumstances of each case.⁸³ It was reasoned that no particular percentage was controlling. The factors to be considered are the nature of the

1964-1 (Part I) CUM. BULL. 142. In Rev. Rul. 70-224, 1970-1 CUM. BULL. 79, it was held that the assets might be transferred directly to the controlled subsidiary without disqualifying the transaction. Under Rev. Rul. 70-107, 1970-1 CUM. BULL. 78, there is no C Type reorganization if assets are transferred to the subsidiary and the parent assumes the debt.

79. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

80. Rev. Proc. 66-34, § 3, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

81. Rev. Proc. 66-34, § 2.03, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

82. Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1937). In this case, the operating properties were 68 percent of the value of the total assets. This case involved the meaning of *substantially all the properties* under the Revenue Act of 1928, § 112(i)(1)(A), ch. 852, 45 Stat. 818. See also Arctic Ice Machine Co., 23 B.T.A. 1223 (1931), modified on stipulation of parties, 67 F.2d 983 (6th Cir. 1933), involving the same provision. The court held a retention of receivables constituting about 32 percent of the net book value of the assets prevented a finding that substantially all the properties had been transferred.

83. Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

properties retained, the purpose of the retention, and the amount. The ruling cited the *Milton Smith* case⁸⁴ to the effect that a transfer of 71 percent of the value of the gross assets was substantially all. The transferor retained cash and accounts receivable aggregating \$52,000, but \$46,000 was required to liquidate liabilities. The ruling also cited a 1927 ruling⁸⁵ to the effect that 75 percent of the value of the gross properties was not substantially all, where a major part of the retained assets were operating assets. The 1957 ruling then concluded that substantially all of the properties were assigned where the transferor retained cash, accounts receivable, notes, and three percent of the inventory. The retained assets were roughly equivalent to the liabilities, and after the transaction the transferor was liquidated.

It appears almost all of the court decisions involving C Type acquisitions stress the operating properties theory. For example, the Court of Appeals for the Third Circuit held the substantially all test satisfied where the retained properties were not related to the transferred operating assets.⁸⁶ The Court of Appeals for the Fifth Circuit suggested that surplus cash should be disregarded in determining whether substantially all the properties had been transferred.⁸⁷ The Court of Appeals for the District of Columbia also held that a retention of cash did not prevent a transfer of substantially all the properties.⁸⁸ There was a similar holding by the Court of Appeals for the First Circuit.⁸⁹ The Board of Tax

84. *Milton Smith*, 34 B.T.A. 702 (1936), *acquiesced in* 1957-2 CUM. BULL. 6.

85. I.T. 2373, VI-2 CUM. BULL. 19 (1927), *declared obsolete* by Rev. Rul. 69-44, 1969-1 CUM. BULL. 312. As indicated in Rev. Rul. 57-518, 1957-2 CUM. BULL. 253, I.T. 2373 is obsolete with respect to its holding as to continuity of interest.

86. *Commissioner v. First Nat'l Bank*, 104 F.2d 865 (3rd Cir. 1939), *appeal dismissed*, 309 U.S. 691 (1940). The transferor retained investment assets equal to 14 percent of the value of the total assets. This case involved the meaning of *substantially all the properties* under the Revenue Act of 1928, § 112(i)(1)(A), ch. 852, 45 Stat. 818. *See also* *Nelson v. United States*, 69 F. Supp. 336 (Ct. Cl. 1947), *cert. denied*, 331 U.S. 846 (1947), *rehearing denied*, 332 U.S. 786 (1947). This case involved the meaning of *substantially all the properties* under the Revenue Act of 1926, § 203(h)(1)(A), ch. 27, 44 Stat. 14.

87. *Gross v. Commissioner*, 88 F.2d 567 (5th Cir. 1937), involving the meaning of *substantially all the properties* under the Revenue Act of 1928, § 112(i)(1)(A), ch. 852, 45 Stat. 818. With the above, compare *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), where the Court indicated *substantially all of the assets* in a D Type acquisition was satisfied by a transfer of approximately 80 percent of the value of the assets other than cash.

88. *Western Industries Co. v. Helvering*, 82 F.2d 461 (C.A. D.C. 1936), involving the meaning of *substantially all the properties* under the Revenue Act of 1926, § 203(h)(1)(A), ch. 27, 44 Stat. 14.

89. *Thurber v. Commissioner*, 84 F.2d 815 (1st Cir. 1936), involving the

Appeal held that the retention of "a few thousand dollars in real estate properties and some worthless bonds" did not prevent a transfer of substantially all the properties.⁹⁰

Recent litigation has involved the meaning of *substantially all of the assets* in acquisitive D Type reorganizations. These cases appear almost unanimous in stressing the operating asset approach.⁹¹

It appears probable that if operating assets are retained, a high percentage of assets must be transferred to meet the substantially all test. The District Court for the Eastern District of Virginia held that a transfer of 81 percent of the value of the assets of the transferor was not substantially all its properties. The retained assets were not used to discharge liabilities.⁹² It would seem that, where assets are retained to retire liabilities of the transferor corporation, a significant percentage of properties must be transferred.⁹³

In summary, it appears the courts and the Revenue Service have adopted the operating properties theory. However, to obtain a favorable ruling the transaction must meet the percentage guidelines laid down by the Revenue Service in its 1966 revenue procedure.

Redemption or Distribution Prior to Acquisition. In some cases, the time to apply the substantially all test must be determined. Assume that just before a reorganization the transferor sells assets, redeems stock, pays dividends or distributes assets to its shareholders. The effect of these transactions must be determined.

In 1972, the Revenue Service announced that unconditional sales of corporate assets to unrelated third parties would not af-

meaning of *substantially all the properties* under the Revenue Act of 1928, § 112(i)(1)(A), ch. 852, 45 Stat. 818.

90. Daily Telegram Co., 34 B.T.A. 101 (1936), involving the meaning of *substantially all the properties* under the Revenue Act of 1924, § 203(h)(1)(A), ch. 234, 43 Stat. 257.

91. See INT. REV. CODE of 1954, §§ 354 (b)(1)(A) and 368 (a)(1)(D); *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); *James Armour, Inc.*, 43 T.C. 295 (1964), *appeal dismissed on stipulation of parties*, (3rd Cir. 1965); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *rehearing denied*, 389 U.S. 893 (1967); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966); *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

92. *National Bank of Commerce v. United States*, 158 F. Supp. 887 (E.D. Va. 1958), involving the meaning of *substantially all the properties* under the Revenue Act of 1926, § 203(h)(1)(A), ch. 27, 44 Stat. 14.

93. See *Civic Center Finance Co. v. Kuhl*, 83 F. Supp. 251 (E.D. Wis. 1948), *aff'd per curiam*, 177 F.2d 706 (7th Cir. 1949).

fect the substantially all test as long as a special condition is met. The sale must occur before the shareholders of the transferor approve the C Type plan of reorganization.⁹⁴

In 1927, the Revenue Service considered a situation where, pursuant to a plan, the acquired corporation distributed part of its properties to its shareholders prior to the acquisition. The Service ruled that the substantially all test should be applied after the distribution.⁹⁵ Logically, the application of this doctrine might be limited to liquid assets usually distributed to shareholders. It might not be applied if the distribution is a shield to conceal a transfer of what is less than substantially all of the properties. In *Helvering v. Elkhorn Coal Co.*,⁹⁶ a corporation transferred unwanted assets to a newly formed corporate subsidiary and distributed the stock to its shareholders. Then, the remaining assets were transferred to an acquiring corporation for its stock. The Court of Appeals for the Fourth Circuit held the acquiring corporation did not obtain substantially all of the properties of the transferor.

It would appear that the tax consequences of the reorganization might depend upon whether the step transaction doctrine is applicable.⁹⁷ If the two transactions are combined, the substantially all test should be measured by reference to the properties of the transferor before the first disposition. It appears to be the present ruling policy of the Internal Revenue Service that very little difficulty is encountered where preferred stock is redeemed. However, the step transaction doctrine may be used to apply the substantially all test where common stock is redeemed.⁹⁸

THE D TYPE

In General. As previously indicated, the D Type reorganization may be either acquisitive or divisive. The requirements to qualify under these two categories are quite different. An acquisitive D Type reorganization involves a transfer by one corpora-

94. Rev. Rul. 72-354, 1972 INT. REV. BULL. No. 29, at 4.

95. GCM 1345, VI-1 CUM. BULL. 15 (1927), declared obsolete by Rev. Rul. 69-44, 1969-1 CUM. BULL. 312. See also *Thurber v. Commissioner*, 84 F.2d 815 (1st Cir. 1936).

96. 95 F.2d 732 (4th Cir. 1937), cert. denied, 305 U.S. 605 (1938), rehearing denied, 305 U.S. 670 (1938), rev'g, 34 B.T.A. 845 (1936), not acquiesced in, XV-2 CUM. BULL. 32 (1936).

97. See note 52 *supra*.

98. See Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*. The procedure states that sales, redemptions or other dispositions of stock occurring prior or subsequent to the exchange will be considered in determining if the continuity of interest test is met. However, the effect of the substantially all test is not discussed.

tion of substantially all of its assets to another. Immediately after the transfer, the transferor, or one or more of its shareholders, must control the transferee.⁹⁹ In addition, the transferor must be liquidated in pursuance of the plan of reorganization.¹⁰⁰ Under this provision, it is not necessary that stock or securities of the transferee be involved. The acquisitive D Type transaction may apply to an all cash sale.¹⁰¹ In divisive D Types, on the other hand, a corporation transfers part of its assets to another. After the transfer, the transferor must control the transferee. In addition, there must be a distribution by the transferor of stock or securities of the transferee in a transaction qualifying under Section 355 of the Internal Revenue Code relating to corporate separations. The distributed stock must constitute control of the transferee.¹⁰²

THE ACQUISITIVE D TYPE

In General. An acquisitive D Type is somewhat similar to the C Type. The differences are as follows:

1. In an acquisitive D Type, substantially all of the assets must be transferred.¹⁰³ In a C Type, substantially all of the properties must be transferred.¹⁰⁴
2. In an acquisitive D Type, the transferor or one or more of its shareholders or any combination thereof must be in control of the transferee.¹⁰⁵ In a C Type, there is no such requirement.¹⁰⁶
3. In an acquisitive D Type, the transferor must be liquidated.¹⁰⁷ In a C Type, there is no such requirement.¹⁰⁸
4. In a C Type, the consideration normally must be solely

99. INT. REV. CODE of 1954, §§ 368(a)(1)(D) and 354(b)(1)(A).

100. INT. REV. CODE of 1954, § 354(b)(1)(B).

101. Rev. Rul. 70-240, 1970-1 CUM. BULL. 81; *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *rehearing denied*, 389 U.S. 893 (1967); *Werner Abegg*, 50 T.C. 145 (1968), *aff'd*, 429 F.2d 1209 (2nd Cir. 1970), *cert. denied*, 400 U.S. 1008 (1971). In *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), it is stated that virtually all F Type reorganizations also qualify as acquisitive D Type reorganizations. Where a reorganization qualifies as an F Type and also as another type of reorganization, it is treated as an F Type reorganization. Rev. Rul. 57-276, 1957-1 CUM. BULL. 126. See also Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, *amplified by* Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

102. INT. REV. CODE of 1954, §§ 368(a)(1)(D) and 355.

103. INT. REV. CODE of 1954, § 354(b)(1)(A).

104. INT. REV. CODE of 1954, § 368(a)(1)(C).

105. INT. REV. CODE of 1954, § 368(a)(1)(D).

106. INT. REV. CODE of 1954, § 368(a)(1)(C).

107. INT. REV. CODE of 1954, § 354(b)(1)(B).

108. See note 65 *supra*.

voting stock.¹⁰⁹ In an acquisitive D Type, there is no such requirement. In fact, the consideration in an acquisitive D Type may be all cash.¹¹⁰

The Code provides that if a transaction is described as both a C Type and an acquisitive D Type, it is to be treated as an acquisitive D Type.¹¹¹

Under the Internal Revenue Code of 1939, the D Type reorganization was defined merely 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 shareholders or both are in control of the corporation to which the assets are transferred.¹¹²

The 1954 Code, however, by virtue of provisions placed in Section 354(b) added two new requirements for an acquisitive D Type:

1. Substantially all of the assets of the transferor must be acquired,¹¹³ and
2. The transferor must be liquidated.¹¹⁴

Thus, under the 1954 Code, it appears somewhat more difficult to qualify as an acquisitive D Type reorganization.

The litigation regarding acquisitive D Types has been principally concerned with constructive reorganizations. The Revenue Service is usually attempting to treat boot as a dividend under Section 356 of the Internal Revenue Code. Such a constructive reorganization will be referred to in this discussion as liquidation followed by reincorporation.

Judge Rives, in *Davant v. Commissioner*,¹¹⁵ mentioned "three common garden varieties" of these transactions. They may be summarized as follows:

1. A corporation transfers some of its properties to a new corporation for stock of the new corporation. The transferor then liquidates distributing stock of the new corporation along with its other assets.¹¹⁶

109. INT. REV. CODE of 1954, § 368(a)(1)(C).

110. Rev. Rul. 70-240, 1970-1 CUM. BULL. 81. In such a case, the entire amount realized on liquidation of the transferor would be boot under INT. REV. CODE of 1954, § 356. Accordingly, it would be subject to dividend treatment.

111. INT. REV. CODE of 1954, § 368(a)(2)(A).

112. INT. REV. CODE of 1939, § 112(g)(1)(D).

113. INT. REV. CODE of 1954, § 354(b)(1)(A).

114. INT. REV. CODE of 1954, § 354(b)(1)(B).

115. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967), rehearing denied, 389 U.S. 893 (1967).

116. *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955).

2. The stockholders of a corporation form a new corporation. The old corporation sells some or all of its assets to the new corporation. The old corporation is then liquidated.¹¹⁷
3. An old corporation is liquidated. The stockholders then transfer some of the assets to a new corporation.¹¹⁸

When the 1954 Code was enacted, the new requirements applicable to acquisitive D Types could be construed to avoid a constructive reorganization in some of these instances. However, the Conference Committee Report on the 1954 Code mentioned the liquidation followed by reincorporation problem and stated:

It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.¹¹⁹

Presumably as a result of this suggestion, the Regulations caution that there may be a reorganization with the result that boot may be treated as a dividend in either of the following situations:

1. A liquidation preceded by a transfer of all or part of the assets of the liquidated company to another, or
2. A liquidation followed by a transfer of all or part of the assets of the liquidated corporation to another.¹²⁰

Substantially All of the Assets of the Transferor. In an acquisitive D Type reorganization, *substantially all of the assets* of the corporation must be transferred.¹²¹ A C Type requires the transfer of *substantially all of the properties*.¹²² In all likelihood, these two phrases have the same meaning.¹²³

117. *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir. 1956), *cert. denied*, 352 U.S. 824 (1956); *Pebble Springs Distilling Co.*, 23 T.C. 196 (1954), *aff'd*, 231 F.2d 288 (7th Cir. 1956), *cert. denied*, 352 U.S. 836 (1956). The sale might also be made to a controlled corporation which was previously in existence.

118. *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955), *aff'g*, 18 T.C. 1255 (1952), *acquiesced in* 1953-1 CUM. BULL. 3; *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947).

119. H.R. Rep. No. 2543, 83rd Cong., 2d Sess. 41 (1954).

120. Treas. Reg. § 1.331-1(c) (1955). *See also* Treas. Reg. § 1.301-1(1) (1955).

121. INT. REV. CODE of 1954, § 354(b)(1)(A).

122. INT. REV. CODE of 1954, § 368(a)(1)(C).

123. *See* Rev. Rul. 70-240, 1970-1 CUM. BULL. 81, dealing with an acquisitive D Type reorganization which cites Rev. Rul. 57-518, 1957-2 CUM. BULL. 253, dealing with a C Type reorganization in connection with the meaning of *substantially all of the assets*. *See also* Ralph C. Wilson, Sr., 46 T.C. 334 (1966), where the Tax Court stated that, "We may assume that 'substantially all of the properties' . . . is to be given the same interpretation as 'substantially all of the assets.'" With the above cases, compare *Gross v. Commissioner*, 88 F.2d 567 (5th Cir. 1937) and *Pillar Rock Packing Co. v. Commissioner*, 90 F.2d 949 (9th Cir. 1937).

The meaning of substantially all in C Type reorganizations has already been discussed. The cases indicate that the operating asset approach is used in determining what is substantially all in acquisitive D Type acquisitions.¹²⁴ In 1970, the Revenue Service ruled that 34/67ths of the fair market value of the assets of a corporation was substantially all in an acquisitive D Type acquisition where they constituted all of its operating assets.¹²⁵

If a taxpayer wishes a ruling in an acquisitive D Type acquisition, the percentage of assets tests prescribed by the Revenue Service must be satisfied. For ruling purposes, the Revenue Service requires that two conditions be met. The assets transferred must have a value of at least 90 percent of the fair market value of the net assets of the transferor. In addition, they must have a value of at least 70 percent of the fair market value of the gross assets of the transferor.¹²⁶

Liquidation of Transferor. The Code requires that the transferor must be liquidated in an acquisitive D Type reorganization.¹²⁷ Thus, it would seem that if there is no liquidation, there is no acquisitive D Type reorganization. However, *David T. Grubbs*¹²⁸ casts some doubt upon this conclusion. There, a corporation transferred assets to a new corporation controlled by its shareholders. The transferor then completely redeemed its stock from every shareholder but one. The Tax Court held this was an acquisitive D Type reorganization, apparently viewing the transaction as a constructive liquidation.

Control. In order to have an acquisitive D Type reorganization, the transferor, or one or more of its shareholders or any combination thereof, must be in control of the transferee immediately after the transfer.¹²⁹ The Tax Court has held that this control requirement is absolutely essential for a transaction to be an acquisitive D Type reorganization.¹³⁰ Thus, if the transferor

124. See the cases cited in note 91 *supra*.

125. Rev. Rul. 70-240, 1970-1 CUM. BULL. 81.

126. Rev. Proc. 66-34, § 3.01, 1966-2 CUM. BULL. 1232, which was modified on other issues as indicated in note 27 *supra*.

127. INT. REV. CODE of 1954, § 354(b)(1)(B). If, after a liquidation, the shareholders had no intent to transfer the assets to a new corporation but later did so for reasons arising after the transfer, strong arguments may be made this is not an acquisitive D Type reorganization. William C. Kind, 54 T.C. 600 (1970), *acquiesced in*, 1970-2 CUM. BULL. xx.

128. David T. Grubbs, 39 T.C. 42 (1962). See also Treas. Reg. § 1.354-1(a)(2) (1955).

129. INT. REV. CODE of 1954, § 368(a)(1)(D). Control is defined as the ownership of 80 percent of the total voting power of all classes of stock entitled to vote and 80 percent of the total number of all other classes of stock. INT. REV. CODE of 1954, § 368(c).

130. Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*,

or its shareholders or any combination thereof do not control the transferee, there is no acquisitive D Type reorganization.

THE DIVISIVE D TYPE

In General. A divisive D Type reorganization requires that part of the assets of one corporation be transferred to another and that the transferor control the transferee. In addition, control of the transferee must be distributed by the transferor in a transaction qualifying under Section 355 of the Internal Revenue Code.¹³¹ Section 355 is a broad provision which deals with corporate separations. It covers more transactions than divisive D Type reorganizations.¹³² The requirements of Section 355 which must be met in all divisive D Type reorganizations are:

1. The transferor must distribute stock or securities of a corporation it controls immediately before the distribution,¹³³
2. The transaction is not used principally as a device for the distribution of earnings and profits of either corporation,¹³⁴
3. The active business requirements of the section are met,¹³⁵ and
4. Control of the subsidiary is distributed.¹³⁶

These requirements will be discussed below.

Control. For purposes of applying Section 355, control has the same meaning as in corporate reorganizations generally. It is 80 percent of the total voting power of all classes of stock en-

1964-2 CUM. BULL. 5. See also *Austin Transit Inc.*, 20 T.C. 849 (1953), *acquiesced in*, 1954-1 CUM. BULL. 3, and *Breech, Jr. v. U.S.*, 439 F.2d 409 (9th Cir. 1971).

131. INT. REV. CODE of 1954, § 368(a)(1)(D). The definition includes control of the transferee by the transferor or one or more of its shareholders or any combination thereof. However, INT. REV. CODE of 1954, § 355, requires control of the transferee by the transferor corporation.

132. For example, INT. REV. CODE of 1954, § 355(a)(2)(C), states the section applies whether or not the distribution is pursuant to a plan of reorganization under INT. REV. CODE of 1954, § 368(a)(1)(D). It also applies whether or not the distribution is pro rata and whether or not the shareholder surrenders stock in the distributing corporation. See INT. REV. CODE of 1954, §§ 355(a)(2)(A) and (B). If no stock held by a shareholder is surrendered, then his basis immediately before the distribution is allocated among the classes of stock after the transaction in proportion to their fair market values. See Treas. Reg. § 1.358-2 (1955).

133. INT. REV. CODE of 1954, § 355(a)(1)(A).

134. INT. REV. CODE of 1954, § 355(a)(1)(B).

135. INT. REV. CODE of 1954, § 355(a)(1)(C). These requirements are discussed below.

136. INT. REV. CODE of 1954, § 355(a)(1)(D).

titled to vote and 80 percent of the total number of shares of all other classes of stock.¹³⁷

Device for Distributing Earnings and Profits. It is essential that the transaction is not a device used principally for the distribution of earnings and profits of any corporation involved. The Code provides that a sale or exchange by some or all of the distributees is not to be construed as such a use unless the sale or exchange was negotiated or agreed upon prior to the distribution.¹³⁸ The Regulations also state this rule. The Regulations provide, however, that a sale after a distribution will be evidence that the transaction was used as such a device.¹³⁹

The Regulations require that the purpose of the transaction be "germane to the business of the corporation."¹⁴⁰ This requirement contemplates a continuity of the entire business enterprise under modified corporate form and a continuity of interest by those who were owners prior to the exchange.¹⁴¹

In *Commissioner v. Morris Trust*,¹⁴² the Court of Appeals for the Fourth Circuit held that there might be a distribution under Section 355 followed by a reorganization of the distributor corporation. In this case, the distributing corporation merged into a national bank after the distribution. The court held it was not necessary for the distributing corporation to continue its business in unaltered corporate form. The Revenue Service agrees that a reorganization of the distributing corporation after the distribution will not have an adverse effect on the distribution.¹⁴³

Active Business Requirement. The corporations involved in

137. INT. REV. CODE of 1954, § 368(c).

138. INT. REV. CODE of 1954, § 355(a)(1)(B).

139. Treas. Reg. § 1.355-2(b) (1955).

140. Treas. Reg. § 1.355-2(c) (1955). In *Commissioner v. Wilson*, 353 F.2d 184 (9th Cir. 1965), the court held that a business purpose for such a transaction was an indispensable requirement. See also Rev. Rul. 69-460, 1969-2 CUM. BULL. 51, and *Rafferty v. Commissioner*, 452 F.2d 767 (1st Cir. 1971), petition for cert. filed, 40 U.S.L.W. 3475 (U.S. March 3, 1972) (No. 71-1123). See also the discussion of the business purpose requirement in reorganizations, below.

141. Treas. Reg. § 1.355-2(c) (1955). See also the discussion of the continuity of business and continuity of proprietary interest in reorganizations, below.

142. 367 F.2d 794 (4th Cir. 1966). Compare, however, *Curtis v. United States*, 336 F.2d 714 (6th Cir. 1964), where a contrary view is expressed.

143. See Rev. Rul. 68-603, 1968-2 CUM. BULL. 148, dealing with an A Type acquisition and Rev. Rul. 70-434, 1970-2 CUM. BULL. 83, dealing with a B Type acquisition. However, such a reorganization of the corporation whose stock is distributed may cause complications. It will disqualify the distribution in a divisive D Type unless the shareholders of the distributing corporation are in control of the acquiring corporation in the subsequent reorganization. Rev. Rul. 70-225, 1970-1 CUM. BULL. 80.

a divisive D Type must meet an active business requirement.¹⁴⁴ A corporation is considered as being engaged in business in either of two situations:

1. Both the distributor and the controlled corporation are directly engaged in the active conduct of a trade or business immediately after the distribution, or
2. Immediately before the distribution the distributing corporation had no assets other than stock or securities of a controlled corporation or corporations and an additional test is met. Each subsidiary must be engaged in the active conduct of a trade or business immediately after the distribution.¹⁴⁵

Active conduct of a trade or business is defined in the Code. It includes directly conducting such an activity as well as holding stock or securities of a controlled subsidiary which is so engaged.¹⁴⁶

In addition, to satisfy the active business requirement, the trade or business must have been actively conducted for five years preceding the distribution.¹⁴⁷ If the trade or business was acquired within the five year period, a special test must be met. The acquisition of the trade or business must not have been one in which gain or loss was recognized in whole or in part.¹⁴⁸

The Regulations define the active conduct of a trade or business. It is a group of activities carried on for the purpose of earning income or profit. It must include every operation in the process of earning income from the group of activities. It does not include certain passive sources of income such as:

144. INT. REV. CODE of 1954, § 355(a)(1)(C). In *Edmund P. Coady*, 33 T.C. 771 (1960), *acquiesced in* 1965-1 CUM. BULL. 4, *aff'd mem.*, 289 F.2d 490 (6th Cir. 1961), the court held that a single business might be divided. This was followed in *United States v. Marett*, 325 F.2d 28 (5th Cir. 1963). In Rev. Rul. 64-147, 1964-1 (Part I) CUM. BULL. 136, the Revenue Service announced it would follow these cases despite the provision to the contrary in Treas. Reg. § 1.355-1(a) (1955).

145. INT. REV. CODE of 1954, § 355(b)(1). In applying the no asset provision, Treas. Reg. § 1.355-4(a)(2) (1955), indicates that a *de minimis* rule is applicable.

146. INT. REV. CODE of 1954, § 355(b)(2)(A).

147. INT. REV. CODE of 1954, § 355(b)(2)(B). For this purpose, five years means five complete years ending on the date of the distribution. *Isbel A. Elliot*, 32 T.C. 283 (1959). See also *Andrew M. Speeris*, 54 T.C. 1353 (1970), *appeal pending to* 7th Cir. Where there are substantial capital additions to the business within the five year period, it must be shown they were substantially financed out of earnings of that business. Rev. Rul. 59-400, 1959-2 CUM. BULL. 114.

148. INT. REV. CODE of 1954, § 355(b)(1)(C). If, during the five year period, the acquisition was of control of a corporation engaged in the active conduct of a trade or business a similar rule applies. INT. REV. CODE of 1954, § 355(b)(1)(D).

1. Holding of stock, securities, land or similar assets for investment purposes even though there may be casual sales,
2. Ownership of land or buildings substantially all of which are used and occupied by the owner in operation of its trade or business, or
3. Activities which are a part of a business operated for profit but which do not independently produce income.¹⁴⁹

Distribution of Control. The final requirement is that the distribution must constitute control of the subsidiary.¹⁵⁰ If the distributing corporation retains any stock or securities of the controlled corporation, a special condition must exist. The retention must not have as one of its principal purposes the avoidance of federal income tax.¹⁵¹ Thus, ordinarily all stock and securities of the controlled corporation held by the distributing company must be transferred.

THE E TYPE

In General. An E Type reorganization is a recapitalization.¹⁵² It is not defined in either the Code or Regulations. The Supreme Court has stated, however, that it is a "reshuffling of a capital structure within the framework of an existing corporation."¹⁵³

The Regulations present several examples of this recapitalization of a single corporation:

1. A corporation discharges outstanding bonds by issuing preferred stock to the bondholders.¹⁵⁴
2. Part of the outstanding preferred stock is retired by issuing common stock.¹⁵⁵

149. Treas. Reg. § 1.355-1(c) (1955). In Rev. Rul. 66-204, 1966-2 CUM. BULL. 113, it was stated that the ownership and management of an investment portfolio of stocks and bonds will never constitute an active trade or business, regardless of size or management activity. In Rev. Rul. 68-284, 1968-1 CUM. BULL. 143, the Revenue Service held that passive receipt of income from leasing vacant land was not the active conduct of a trade or business.

150. INT. REV. CODE of 1954, § 355(a)(1)(D). Control has the same meaning as used in the other reorganization provisions. INT. REV. CODE of 1954, § 368(c).

151. Treas. Reg. § 1.355-2(d) (1955). The Regulations state that ordinarily the business reasons requiring any distribution will require a distribution of all stock and securities of the transferee held by the distributing corporation.

152. INT. REV. CODE of 1954, § 368(a)(1)(E).

153. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194 (1942), *rehearing denied*, 315 U.S. 829 (1942), *second petition for rehearing denied*, 316 U.S. 710 (1942).

154. Treas. Reg. § 1.368-2(e)(1) (1955).

155. Treas. Reg. § 1.368-2(e)(2) (1955).

3. A corporation issues authorized but unissued preferred stock for outstanding common stock.¹⁵⁶
4. An exchange is made by shareholders of outstanding preferred stock having dividend and liquidation priorities for common stock having no such rights.¹⁵⁷
5. An exchange is made by shareholders of outstanding preferred stock of a corporation with dividends in arrears. They receive either common or preferred stock covering the value of the old stock and the dividend arrearage.¹⁵⁸

The Court of Appeals for the Seventh Circuit has held that a refinancing of securities in which new securities are issued for old ones is a recapitalization.¹⁵⁹ Such a transaction is an exception to the general rule that there must be a continuity of proprietary interest.¹⁶⁰

If the principal amount of securities received in a recapitalization exceeds the principal amount surrendered, the fair market value of the excess is boot. In such a case, gain is recognized to the extent of the fair market value of the boot.¹⁶¹

The exchange of stock for bonds is not a recapitalization. This is merely a redemption of stock.¹⁶²

Illustration. One frequent use of a corporate recapitalization involves a closely held corporation. For example, an employee-shareholder may wish to retire and convert his common stock to a more passive investment. This might allow the active officers to become sole common shareholders. As a consequence, there may be an exchange of common stock for preferred stock. The Tax Court held this to be a recapitalization.¹⁶³

Liquidation Followed by Reincorporation. In the discus-

156. Treas. Reg. § 1.368-2(e)(3) (1955).

157. Treas. Reg. § 1.368-2(e)(4) (1955).

158. Treas. Reg. § 1.368-2(e)(5) (1955).

159. Commissioner v. Bachrach, 192 F.2d 261 (7th Cir. 1950).

160. Continuity of proprietary interest is discussed later. See Alan O. Hickok, 32 T.C. 80 (1959), *not acquiesced in* 1959-2 CUM. BULL. 8, involving INT. REV. CODE of 1939, § 112(g)(1)(E).

161. INT. REV. CODE of 1954, § 356. In Rev. Rul. 69-34, 1969-1 CUM. BULL. 105, the Revenue Service ruled on cash distributions in E type reorganizations in lieu of fractional shares. If the tests set forth with respect to B and C Type reorganizations are met, the cash distribution is treated as being in redemption of the fractional share interests. See notes 49 and 76 *supra*. See also Rev. Rul. 72-57, 1972 INT. REV. BULL. No. 7, at 7.

162. Bazley v. Commissioner, 331 U.S. 737 (1947), *rehearing denied and amended*, 332 U.S. 752 (1947).

163. Elmer M. Hartzel, 40 B.T.A. 492 (1939), *acquiesced in*, 1939-2 CUM. BULL. 16; Marjorie N. Dean, 10 T.C. 19 (1948), *acquiesced in*, 1949-1 CUM. BULL. 1.

sion above concerning the acquisitive D Type reorganizations, reference was made to a group of tax avoidance activities. They were referred to for convenience as liquidation followed by reincorporation. In 1961, the Revenue Service ruled that these transactions might be classed as constructive E Type reorganizations.¹⁶⁴ The result is that boot retained by the shareholders might be taxed as dividends to them.¹⁶⁵ These transactions invariably involve more than one corporation. Accordingly, the courts have held that they are not constructive E Type reorganizations, particularly where there is a substantial shift in proprietary interests.¹⁶⁶

THE F TYPE

In General. The F Type reorganization is defined as "a mere change in identity, form, or place of organization, however effected."¹⁶⁷ Prior to the adoption of the 1954 Code, the use and applicability of this provision was extremely obscure. The House of Representatives version of the 1954 Code deleted the F Type as unnecessary.¹⁶⁸ However, the provision was restored by the Senate and became a part of the 1954 Code.¹⁶⁹ In Section 381 of the 1954 Code, it is provided that the taxable year of a corporation in an F Type reorganization does not close on the acquisition date.¹⁷⁰ As a result, the F Type reorganization became of much more importance. In 1957, the Revenue Service ruled that if a transaction qualifies as an F Type and also as an A, C, or D Type, it is to be treated only as an F Type reorganization.¹⁷¹ The

164. Rev. Rul. 61-156, 1961-2 CUM. BULL. 62. In this ruling, the shareholders of the old corporation owned only 45 percent of the new corporation. Thus, there could not be an acquisitive D Type reorganization. Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5; Austin Transit, Inc., 20 T.C. 849 (1953), *acquiesced in*, 1954-1 CUM. BULL. 3; Breech, Jr. v. U.S., 439 F.2d 409 (9th Cir. 1971). The possible application of the F Type reorganization to these transactions is discussed below.

165. INT. REV. CODE of 1954, § 356. See also Treas. Reg. § 1.301-1(1) (1955).

166. Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5; Turner Advertising, Inc., 25 CCH Tax Ct. Mem. 532 (1966). See also Reef Corp., 24 CCH Tax Ct. Mem. 379 (1965), *rev'd*, on grounds transaction was an F Type reorganization, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967).

167. INT. REV. CODE of 1954, § 368(a)(1)(F).

168. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A115 (1954), where it is stated, "The provisions of Section 112(g)(1)(F) . . . have been deleted as unnecessary." The reference is to the Internal Revenue Code of 1939.

169. S. Rep. No. 1622, 83rd Cong., 2d Sess. 272 *et seq.* (1954).

170. INT. REV. CODE of 1954, § 381(b). There is also a reference in INT. REV. CODE of 1954, § 1244(d)(2), that Section 1244 stock retains its classification after an F type reorganization. Section 1244 stock is stock, the loss on which within limits may be treated as ordinary loss rather than capital loss.

171. Rev. Rul. 57-276, 1957-1 CUM. BULL. 126. See also Rev. Rul. 58-422,

most common example is where a corporation merely changes the state in which it is incorporated.

Nature of Transaction. In *Helvering v. Southwest Consolidated Corp.*,¹⁷² the Supreme Court stated that the F Type is "inapplicable where there is a shift in proprietary interest." Under this view, it would seem there might be only the simplest of corporate changes in an F Type transaction.¹⁷³ The Revenue Service has stated that in an F Type there must be an identity of assets and shareholders before and after the transaction. However, the Service approved an F Type where dissenting shareholders owning less than one percent of the transferor did not receive stock. This change in proprietary interest was considered too small to disqualify the F Type reorganization.¹⁷⁴

Multiple Corporate F Types. There has been considerable litigation over whether more than one corporation may be involved in an F Type reorganization. The Court of Appeals for the Ninth Circuit in *Stauffer v. Commissioner*¹⁷⁵ and again in *Associated Machine v. Commissioner*¹⁷⁶ held that there might be a valid F Type reorganization involving two or more active corporations as long as there was identical proprietary interest. The Court of Appeals for the Fifth Circuit in *Home Construction Corp. of America v. United States*¹⁷⁷ held that a combination of 123 corporations was an F Type reorganization where the owner-

1958-2 CUM. BULL. 145, amplified by Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

172. 315 U.S. 194 (1942), rehearing denied, 315 U.S. 829 (1942), second petition for rehearing denied, 316 U.S. 710 (1942). In *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967), the Court questioned the correctness of this statement under the Internal Revenue Code of 1954.

173. *Hyman v. Berghash*, 43 T.C. 743 (1965), aff'd, 361 F.2d 257 (2d Cir. 1966).

174. Rev. Rul. 66-284, 1966-2 CUM. BULL. 115. Compare the contention by the Revenue Service in *Casco Products Corp.*, 49 T.C. 32 (1967), appeal dismissed (2d Cir. 1968). The Service contended that a 9 percent change in proprietary interest precluded an F Type reorganization. The issue was not decided since the Tax Court held no reorganization was involved.

175. 403 F.2d 611 (9th Cir. 1968), rev'g 48 T.C. 277 (1967). This case was questioned in *Kansas Sand and Concrete, Inc.*, 56 T.C. 522 (1971), aff'd — F.2d — (10th Cir. July 28, 1972).

176. 403 F.2d 622 (9th Cir. 1968), rev'g 48 T.C. 318 (1967). This case was questioned in *Kansas Sand and Concrete, Inc.*, 56 T.C. 522 (1971), aff'd — F.2d — (10th Cir. July 28, 1972).

177. 439 F.2d 1165 (5th Cir. 1971). Since the transaction qualified as an F type reorganization, net operating losses of the successor might be carried back to offset income earned by the predecessor. INT. REV. CODE OF 1954, § 381(b)(3). The *Home Construction* case was questioned in *Kansas Sand and Concrete, Inc.*, 56 T.C. 522 (1971), aff'd — F.2d — (10th Cir. July 28, 1972). See also *Dunlap & Associates, Inc.*, 47 T.C. 542 (1967), where the Tax Court construed a transaction as being three separate reorganizations. One was an F Type and the other two B Types.

ship, manner of operations, and locations remained the same. The Revenue Service has indicated that it does not agree with this theory.¹⁷⁸

Liquidation Followed by Reincorporation. In the discussion above covering acquisitive D Type reorganizations and again concerning E Type reorganizations, reference was made to a group of tax avoidance activities. They were referred to for convenience as liquidation followed by reincorporation. The Revenue Service has not restricted its attack on the liquidation followed by reincorporation situation to the acquisitive D and E Type transactions.¹⁷⁹ The Service also contends that such transactions may constitute F Type reorganizations. The result is that the shareholders may have taxable boot equal to the fair market value of corporate assets which are not transferred to the surviving corporation.¹⁸⁰ Until recently, the F Type argument did not appear to influence the courts. They generally held such transactions were not F Type reorganizations.¹⁸¹ In *Davant*,¹⁸² however, the Court of Appeals for the Fifth Circuit held an F Type reorganization to apply where the corporate business continued uninterrupted with no shift in proprietary interests. In *Reef Corp. v. Commissioner*¹⁸³ the Court of Appeals for the Fifth Circuit again found

178. Rev. Rul. 69-185, 1969-1 CUM. BULL. 108. However, the Revenue Service position only applies to operating companies. See also Rev. Rul. 69-413, 1969-2 CUM. BULL. 55, where the Revenue Service ruled that an acquisition of assets of one subsidiary by another in a C Type acquisition was not an F Type reorganization.

179. These transactions are illustrated above under acquisitive D Type reorganizations. If, after a liquidation, the shareholders had no intent to transfer the assets to a new corporation but later did so for reasons arising after the transfer, strong arguments may be made that this is not an F Type reorganization. William C. Kind, 54 T.C. 600 (1970), *acquiesced in*, 1970-2 CUM. BULL. xx.

180. Rev. Rul. 61-156, 1961-2 CUM. BULL. 62.

181. *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965); Hyman H. Berghash, 43 T.C. 763 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966); Joseph C. Gallagher, 39 T.C. 144 (1962), *acquiesced in result only*, 1964-2 CUM. BULL. 5; *Turner Advertising, Inc.*, 25 CCH Tax Ct. Mem. 532 (1966); *Book Production Industries, Inc.*, 24 CCH Tax Ct. Mem. 339 (1965).

182. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967), *rehearing denied*, 389 U.S. 893 (1967). Since the transaction was an F Type reorganization, the court held that the earnings and profits of both corporations were to be aggregated to determine the amount taxable as a dividend under INT. REV. CODE of 1954, § 356. The *Davant* case was questioned in *Ross Michael Simon Trust v. U.S.*, 402 F.2d 272 (Ct. Cl. 1968), *Kansas Sand and Concrete, Inc.*, 56 T.C. 522 (1971), *aff'd* — F.2d — (10th Cir. July 28, 1972), and *Breech, Jr. v. U.S.*, 439 F.2d 409 (9th Cir. 1971).

183. 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967). See also *Griswold v. Commissioner*, 400 F.2d 427 (5th Cir. 1968). In *Columbia Gas, Inc. v. U.S.*, 446 F.2d 320 (3rd Cir. 1971), the court cited the *Reef Corporation* case and stated by dicta it was clear that a shift in ownership may not bar an F type reorganization. In addition, see *Gordon v. Commissioner*, 424 F.2d 384 (2d Cir. 1970), *cert. denied*, 400 U.S. 848 (1970).

an F Type reorganization, even though a 48 percent stock interest was eliminated.¹⁸⁴ The Tax Court still maintains that there may never be a shift of a proprietary interest in an F Type reorganization.¹⁸⁵ At this point, it is premature to say what the ultimate outcome of the liquidation followed by reincorporation controversy will be. Perhaps only a decision by the Supreme Court will settle the matter.

VOTING STOCK

In General. In a B Type reorganization, the consideration must be solely voting stock.¹⁸⁶ In a C Type reorganization, the consideration normally is solely voting stock.¹⁸⁷ Voting stock includes any class of stock which has a right to vote for any or all the corporate directors.¹⁸⁸ However, stock is not voting stock if its right to vote on the election of directors is contingent on a future event which has not yet occurred, such as failure to pay dividends.¹⁸⁹

184. The theory was that there was a continuing corporation. As a result, the elimination of the proprietary interest was merely a stock redemption by a single corporation under INT. REV. CODE of 1954, § 302.

185. Estate of Henry P. Lammerts, 54 T.C. 420 (1970), *aff'd and remanded on other issues*, 456 F.2d 681 (2d Cir., March 15, 1972). The Tax Court stated that to the extent Reef Corp. v. Commissioner, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), was inconsistent with these continuity of interest principles, it disagreed.

186. INT. REV. CODE of 1954, § 368(a)(1)(B). If a shareholder of the acquired company is employed at an unreasonable consideration after the transaction, the acquisition may be taxable. The acquisition in substance may not be solely for voting stock. However, under Rev. Rul. 67-275, 1967-2 CUM. BULL. 142, the acquiring corporation may agree to register the stock with the Securities and Exchange Commission without disqualifying the acquisition. If the stock is convertible voting preferred stock having rights to purchase additional shares of the same or another corporation at a future date, it is not solely voting stock. Rev. Rul. 70-108, 1970-1 CUM. BULL. 78. The fact that the stock is convertible into other stock of the same corporation should have no adverse effect on its qualification. The informal position of the Revenue Service appears to be that stock of a subsidiary which is convertible into stock of its parent within a short period of time may disqualify the reorganization. However, it would not if the conversion could not be exercised until after the expiration of a five year period. With this discussion, compare note 6 *supra*. The same conclusion should apply where the conversion is to stock of an unrelated corporation. It also appears to be the informal view of the Revenue Service that the conversion of stock into stock of another corporation is a taxable event. With the above, compare Vrooman, *Corporate Acquisitions—(B) Reorganizations*, 78-2nd TAX MANAGEMENT PORTFOLIO A-23 (1969).

187. INT. REV. CODE of 1954, § 368(a)(1)(C).

188. Erie Lighting Co. v. Commissioner, 93 F.2d 883 (1st Cir. 1937); Rev. Rul. 63-234, 1963-2 CUM. BULL. 148; Rev. Rul. 69-126, 1969-1 CUM. BULL. 218.

189. Vermont Hydro-Electric Corp., 29 B.T.A. 1006 (1934), *acquiesced in*, XIII-1 CUM. BULL. 16 (1934); Rev. Rul. 71-83, 1971-1 CUM. BULL. 268. See also Treas. Reg. § 1.302-3(a) (1955). See Forrest Hotel Corp. v. Fly, 112 F. Supp. 782 (S.D. Miss. 1953), where the court held, in a questionable decision,

Qualifications for Stock. Sometimes it is not clear whether an instrument is stock. Clearly convertible debentures are not.¹⁹⁰ Passbooks of savings and loan associations are not.¹⁹¹ It is doubtful if stock warrants are stock even though they have the right to vote and receive dividends.¹⁹² However, the fact that stock is subject to a buy-sell agreement does not adversely affect its qualification.¹⁹³

Illustration of Principles. The Revenue Service ruled preferred stock was voting stock where it was entitled to elect two out of twelve members of the board of directors.¹⁹⁴ In this ruling, the Revenue Service indicated these shareholders had rights constituting a significant participation in management of the corporation. The necessity of such a significant participation is questionable, however. Assume Transferee Corporation has 3,000,000 shares of voting stock issued and outstanding. Transferee exchanges 3,000 shares of its voting stock for all the stock or assets of Transferor Corporation. No person would seriously contend that the 3,000 shares conferred a significant participation in the management of Transferee. However, the Revenue Service issues favorable rulings without question that transactions such as this qualify as A, B, or C Type reorganizations.

CONTINGENT STOCK

Qualification as Stock. Frequently corporate acquisitions, principally of the A, B or C Type, are made with contingent consideration based on future events. Examples of these contingencies include tax deficiencies, lawsuits, unrecorded liabilities, future profits, or similar items. Usually a portion of the stock is issued on the acquisition date and the balance at a later date. Many times certificates of beneficial interest are issued representing the contingent stock. Where contingent rights to acquire

that common stock which could not vote at the time of the B Type acquisition should be treated as voting stock since it might vote later under certain circumstances.

190. Rev. Rul. 69-91, 1969-1 CUM. BULL. 106. In Rev. Rul. 71-83, 1971-1 CUM. BULL. 268, the Revenue Service ruled that convertible nonvoting stock which was limited and preferred as to dividends was not voting stock under INT. REV. CODE of 1954, § 1504, dealing with consolidated income tax returns.

191. Rev. Rul. 69-6, 1969-1 CUM. BULL. 104.

192. Rev. Rul. 69-6, 1969-1 CUM. BULL. 104; Rev. Rul. 72-198, 1972 INT. REV. BULL. No. 17, at 29. See Estate of Nettie S. Miller, 43 T.C. 760 (1965), *not acquiesced in*, 1966-1 CUM. BULL. 4, *appeal dismissed*, (7th Cir. 1965), where such instruments were classed as stock under the foreign personal holding company provisions.

193. U.S. v. Adkins-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968).

194. Rev. Rul. 63-234, 1963-2 CUM. BULL. 148; Rev. Rul. 69-126, 1969-1 CUM. BULL. 218.

stock, rather than stock itself, are issued in a reorganization, a question arises whether it is stock. Usually it must be treated as voting stock if the acquisition is to qualify as a B or C Type transaction. The Revenue Service in the past attempted to classify such contingent rights as consideration other than stock. In *Carlberg v. United States*,¹⁹⁵ the Court of Appeals for the Eighth Circuit held that negotiable certificates of contingent interest representing stock withheld until settlement of the uncertainties should be treated as stock. The Tax Court in *James C. Hamrick*¹⁹⁶ followed the *Carlberg* decision. In both *Carlberg* and *Hamrick*, the contingent rights to receive additional shares of stock were treated as stock since the certificate holders could receive only stock. Faced with these adverse decisions, the Revenue Service reversed its position. The Service does not attempt to treat the certificates as other property in all cases as long as the certificates are not transferable.¹⁹⁷ The Service will issue favorable rulings in transactions involving contingent stock as long as the following six conditions are met:

1. All of the stock must be issued within five years from the date of the initial distribution.
2. There must be a valid business reason for not issuing all of the stock immediately. An example would be difficulty in determining the value of any of the corporations involved in the reorganization.
3. The maximum number of shares which ultimately may be issued is stated.
4. At least half of the maximum number of shares of each class of stock which may be transferred is issued initially.
5. The contingent right does not allow receipt of anything except additional stock in the acquiring corporation or, where applicable, a corporation controlling it.
6. The agreement evidencing the right to receive stock in the future either:
 - a. prohibits assignment other than by operation of law, or
 - b. the right to the contingent stock is not evidenced

195. 281 F.2d 507 (8th Cir. 1960). In this case, the certificates of contingent interest were transferable.

196. 43 T.C. 21 (1964), *acquiesced in result only*, 1966-1 CUM. BULL. 2. The Revenue Service appeal was dismissed and an order entered vacating the appeal of the taxpayer. The case was remanded for entry of a revised judgment reflecting the agreement of the parties. 17 Am. Fed. Tax R.2d 357, 66-1 U.S. Tax Cas. 85, 682 (4th Cir. 1965).

197. Rev. Rul. 66-112, 1966-1 CUM. BULL. 68; Rev. Rul. 67-90, 1967-1 CUM. BULL. 79.

by negotiable certificates of any kind and is not readily marketable.¹⁹⁸

Retroactive Conversion to Taxable Event. If there is an acquisition with contingent stock, the transaction may be converted retroactively into a taxable transaction should the acquiring corporation itself be acquired before the contingent stock is issued. If stock of a second acquiring corporation is substituted for the contingency, this may disqualify the first acquisition. The Revenue Service may view this as property other than stock of the first acquiring corporation. Thus, the initial transaction might not qualify as a reorganization. The problem might be avoided by a special provision in the first acquisition agreement that the contingency could be accelerated by issuance of stock of the first acquiring corporation before it is acquired by another corporation. Then the consideration in the first acquisition would be stock of the first acquiring corporation. As a consequence, the second acquisition would have no adverse effect on the first one. Another solution might be for the first acquiring corporation to be survivor in any subsequent acquisition. The informal view of the Revenue Service is in accord with both of these conclusions.

Basis. There is an unresolved problem concerning basis where contingent stock is involved. Assume some of the issued shares are sold by a shareholder before it is determined how many shares ultimately will be issued to him. The basis of the shares sold must be determined at the time of sale. For ruling purposes, the Revenue Service takes a very conservative position. The basis is allocated as if the maximum number of shares will be issued. Whether this view will be sustained by the courts is problematical. If this position is sustained, the taxpayer should be entitled to a loss deduction if later it is determined that the maximum number of shares will not be issued.¹⁹⁹

IMPUTED INTEREST ON CONTINGENT STOCK

In General. Section 483 of the Internal Revenue Code was added by the Revenue Act of 1964.²⁰⁰ It deals, in general, with

198. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, modified on other issues as indicated in note 27 *supra*; Rev. Proc. 67-13, 1967-1 CUM. BULL. 590, in which Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, was amplified on this point.

199. Compare, as to general theory, Rev. Rul. 55-119, 1955-1 CUM. BULL. 352, dealing with private annuities, and Ellis, *Private Annuities in Estate Planning*, 109 TRUSTS AND ESTATES 995, 998 (1970). See also *Arrowsmith v. Commissioner*, 344 U.S. 6 (1952), *rehearing denied*, 344 U.S. 900 (1952). It would seem that the deduction in such a case should be in the year the contingency is resolved. The informal position of the Revenue Service is that this is the case.

200. Section 224 of the Revenue Act of 1964.

situations where property is sold for deferred payments with either no or an unusually low rate of interest. In such cases, interest is imputed. This provision applies where the effective interest rate, if any, is less than four percent per annum simple interest.²⁰¹ In the event the four percent test is not met, the rate to be used in imputing interest is five percent per annum compounded semi-annually.²⁰²

The Regulations make it clear that the imputed interest concept applies to the transfer of contingent stock in corporate reorganizations.²⁰³ Thus, issuance of the contingent stock represents, in part, deductible interest expense of the acquiring corporation and taxable interest income to the recipient. The Regulations state that even though some of the stock is treated as interest, this does not make the original transaction a taxable one.²⁰⁴ The solely for voting stock requirement is deemed satisfied in such cases.

ESCROWED STOCK

Distinguished from Contingent Stock. There is a distinction between contingent stock and escrowed stock. Under a contingent stock arrangement, only a portion of the stock consideration of the acquiring corporation is issued currently. Under the escrowed stock arrangement, all the stock consideration is issued but part of it is placed in escrow. The escrowed stock may have the right to vote currently with any dividends being paid to the registered owner. However, the stock may be returned to the acquiring corporation upon the happening of a subsequent event, such as a determination of undisclosed liabilities of the transferor or failure to meet earning levels. The Revenue Service takes the position that a contingent stock arrangement does not represent a closed transaction for tax purposes. The escrowed stock arrangement, however, is a closed transaction.²⁰⁵ Thus, the imputed interest theory is not applicable to escrowed stock.

Subsequent Taxable Event. Suppose the escrowed stock is returned to the acquiring corporation under the contingency provided for in the agreement. There is a possibility that the share-

201. Treas. Reg. § 1.483-1(d) (1966).

202. Treas. Reg. § 1.483-1(c)(2) (1966).

203. Treas. Reg. § 1.483-2(a)(2) (1966); Treas. Reg. § 1.483-1(b)(6), example (7) (1966).

204. Treas. Reg. § 1.483-2(a)(2) (1966). If contingent stock is used, this may make it more difficult to qualify as a pooling of interest for financial purposes. See para. 47g of A.P.B. Opinion No. 16, Business Combinations, August, 1970.

205. Rev. Rul. 70-120, 1970-1 CUM. BULL. 124; Treas. Reg. § 1.483-1(b)(6) (1966), examples (7) and (8).

holder may recognize gain at that time. The gain might be the excess of the value of the stock at the time returned to the acquiring corporation over the tax basis allocated to it at the time of the original acquisition. Whether this theory will be accepted by the courts is problematical. The answer must await further developments.

It would appear that there is very little likelihood of a taxable event when the contingency is the failure to maintain earning levels. If the contingency is a breach of warranty, there may be more arguments that the return of the shares to the acquiring corporation is a taxable event.²⁰⁶

PLAN OF REORGANIZATION AND PARTIES THERETO

Plan of Reorganization. In order to qualify for nonrecognition of gain, exchanges must be pursuant to a plan of reorganization, but the term *plan of reorganization* is not defined in either the Code or Regulations. However, the Regulations indicate that the phrase is not intended to broaden the definition of a reorganization.²⁰⁷ The plan refers to a consummated transaction, germane to a corporate business purpose.²⁰⁸ It apparently is intended to include all steps which are necessary to consummate the transaction entered into by the parties. The courts have held that a plan may exist although it is oral.²⁰⁹ It has also been held that a plan does not lapse where there have been substantial delays.²¹⁰ The Regulations discuss the records to be maintained by the corporate parties to a reorganization. They require that the plan of reorganization be adopted by each of the corporate parties. This adoption is to be by acts of duly constituted responsible corporate officers appearing upon the official records of the corporation.²¹¹ However, this requirement is not applicable to the acquired corporation in a B Type reorganization. Such a corporation does not acquire or transfer property.

In a C Type reorganization, the plan of reorganization usually provides for the liquidation of the transferor corporation although such a liquidation is not required. It has been held, however, that where a plan did not specifically provide for such a

206. See Tillinghast, *Contingent Stock Pay-Outs in Tax-Free Reorganizations*, 22 TAX LAWYER 467, 485 (1969).

207. INT. REV. CODE of 1954, §§ 354 and 361; Treas. Reg. § 1.368-2(g) (1955).

208. Treas. Reg. § 1.368-2(g) (1955). This provision requires the business of one of the parties to the reorganization to continue. However, see the discussion under continuity of interest, below.

209. William H. Redfield, 34 B.T.A. 967 (1936); James G. Murrin, 24 T.C. 502 (1955), *acquiesced in*, 1955-2 CUM. BULL. 7.

210. W. N. Fry, 5 T.C. 1058 (1945), *acquiesced in*, 1954-1 CUM. BULL. 4.

211. Treas. Reg. § 1.368-3(a) (1955).

liquidation, a subsequent liquidation of the transferor might be part of the plan under the step transaction doctrine.²¹²

Parties to a Reorganization. Parties to a reorganization include the following:

1. The corporation resulting from a reorganization.²¹³
2. Both corporations where one acquires stock or properties of another.²¹⁴
3. A corporation receiving stock or assets even though it transfers all or a part of them to a controlled subsidiary.²¹⁵
4. The parent which controls the acquiring corporation where the consideration is stock of the parent in an A, B, or C Type reorganization.²¹⁶
5. The parent which controls the acquired corporation where the transaction qualifies as an A Type reorganization.²¹⁷

CONTINUITY OF INTEREST

In General. For an acquisition to qualify as a reorganization, there must be continuity of interest. Continuity of interest consists of both continuity of business and continuity of proprietary interest.

Continuity of Business. The Regulations provide that the transaction "must be an ordinary and necessary incident of the conduct of the enterprise and must provide for a continuation of the enterprise."²¹⁸ In at least two cases, the taxpayer, seeking to defeat a reorganization, contended that continuity of business required that the acquiring corporation continue the identical business previously conducted. The Revenue Service contended that continuation by the surviving corporation of any business activity was sufficient. Both the Court of Appeals for the Second Circuit²¹⁹ and the Seventh Circuit²²⁰ upheld the Revenue Service. The Rev-

212. *Nelson v. United States*, 69 F. Supp. 336 (Ct. Cl. 1947), *cert. denied*, 331 U.S. 846 (1947), *rehearing denied*, 332 U.S. 786 (1947).

213. INT. REV. CODE of 1954, § 368(b)(1).

214. INT. REV. CODE of 1954, § 368(b)(2).

215. INT. REV. CODE of 1954, § 368(b).

216. *Id.*

217. *Id.*

218. Treas. Reg. § 1.368-1(c) (1955). *See also* Treas. Reg. § 1.368-1(b) (1955).

219. *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955).

220. *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir. 1956), *cert. denied*, 352 U.S. 836 (1956). *See also* *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961).

enue Service has ruled that the continuity of business requirement is satisfied in a C Type reorganization if the surviving corporation is organized to engage in a business enterprise.²²¹ Thus, it appears that any business activity, whether that of the transferee, the transferor, or an entirely new business, satisfies the requirement. There appears to be no reason why the rationale of this ruling should not cover every type of reorganization.

Continuity of Proprietary Interest. The purpose of the reorganization provisions is to allow shareholders of the transferor corporation to acquire a continuing interest in the transferee without the imposition of an income tax. Therefore, it is a requirement of all reorganizations that the shareholders of the transferor continue to participate in ownership. In a 1939 Code decision the Tax Court held that continuity of proprietary interest was not necessary in an E Type reorganization.²²² This case would seem to be invalid under the 1954 Code except where there is a refinancing of securities.

Continuity of proprietary interest has, to a certain extent, been codified in the B and C Type reorganizations and in one specialized A Type acquisition by voting stock provisions. It has also been codified in the D Type reorganization by the control requirement immediately after the transfer. In an A Type reorganization, however, the acquiring corporation generally may use consideration other than stock, such as bonds or cash.

The continuity of proprietary interest requirement is very ably summarized by the Court of Appeals for the Fifth Circuit as follows:

[There must be] a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, (2) that such retained interest represents a substantial part of the value of the property transferred.²²³

The continuity of proprietary interest may be satisfied only by an equity interest, evidenced by common or preferred stock,

221. Rev. Rul. 63-29, 1963-1 CUM. BULL. 77. This ruling revoked Revenue Ruling 56-330, 1956-2 CUM. BULL. 204, which expressed the contrary view.

222. Alan O. Hickok, 32 T.C. 80 (1959), *not acquiesced in*, 1959-2 CUM. BULL. 8.

223. *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir. 1951), *cert. denied*, 342 U.S. 860 (1951). A corporation may purchase all of the stock of a corporation and then merge it into another subsidiary. In such a case, there is no continuity of interest and thus no reorganization, *Estate of James F. Suter*, 29 T.C. 244 (1957), *acquiesced in*, 1958-2 CUM. BULL. 8; *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965).

whether voting or nonvoting.²²⁴ What the term *substantial* means is uncertain. However, it has been held that the relationship of the transferor to the transferred assets need not remain unchanged.²²⁵ In *Helvering v. Minnesota Tea Co.*,²²⁶ the Supreme Court held that equity consideration representing 56 percent of the total consideration was a substantial part of the value of the property transferred. In *Miller v. Commissioner*,²²⁷ the Court of Appeals for the Sixth Circuit held that a 25 percent equity interest satisfied the continuity of interest requirement. On the other hand, the ratio of equity to total consideration of less than one percent in one case²²⁸ and approximately 17 percent in another²²⁹ did not. The Revenue Service ruling policy is that the equity consideration must be at least 50 percent of the total consideration received.²³⁰

Not all the shareholders of the acquired corporation need to have a proprietary interest in the surviving corporation after the acquisition.²³¹ Under the Revenue Service ruling policy, the 50 percent test may be satisfied by one or more shareholders out of the group.

To obtain a favorable ruling on a reorganization it must be represented that the shareholders have no present intention to dispose of enough stock to reduce their holdings below the 50 percent requirement. Should enough stock be disposed of shortly

224. *Le Tulle v. Scofield*, 308 U.S. 415 (1940), *rehearing denied*, 309 U.S. 694 (1940); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933); *Pinellas Ice and Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Commissioner*, 296 U.S. 374 (1935).

225. *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936); *See also Miller v. Commissioner*, 103 F.2d 58 (6th Cir. 1939).

226. 296 U.S. 378 (1935), *aff'g* 76 F.2d 797 (8th Cir. 1935). The opinion of the Court of Appeals for the Eighth Circuit reveals that the consideration was cash of \$426,842.52 and stock having a market value of \$540,000.00. This results in a ratio of stock to total consideration of about 56 percent. *See also Britt v. Commissioner*, 114 F.2d 10 (4th Cir. 1940).

227. 84 F.2d 415 (6th Cir. 1936); *See also Miller v. Commissioner*, 103 F.2d 58 (6th Cir. 1939).

228. *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir. 1951), *cert. denied*, 342 U.S. 860 (1951).

229. *Banner Machine Co. v. Routzahn*, 107 F.2d 147 (6th Cir. 1939), *cert. denied*, 309 U.S. 676 (1940), *rehearing denied*, 310 U.S. 656 (1940). The value of the equity interest was \$96,000 as compared to \$500,000 cash received. The equity represented about 17 percent of the total consideration.

230. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, *as amplified* by Rev. Proc. 67-13, 1967-1 CUM. BULL. 590. Revenue Procedure 66-34 was modified on other issues as indicated in note 27 *supra*.

231. *Reilly Oil Co. v. Commissioner*, 189 F.2d 382 (5th Cir. 1951); *Western Mass. Theatres, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956); *Miller v. Commissioner*, 84 F.2d 415 (6th Cir. 1936). *See also Miller v. Commissioner*, 103 F.2d 58 (6th Cir. 1939).

after a purported reorganization, this may be considered evidence that there was no continuity of proprietary interest. This is particularly true where the disposition was in accordance with a prior commitment to sell.²³²

BUSINESS PURPOSE

In General. The business purpose requirement is, in effect, an extension of the continuity of business test. It is applied to disqualify purported reorganizations which merely facilitate tax avoidance. In *Gregory v. Helvering*,²³³ the Supreme Court held that a transaction which met the literal form of a reorganization was disqualified where the primary purpose was that of tax avoidance rather than a business purpose. The Regulations contain the following emphatic language:

The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures . . . as are required by *business exigencies* and which effect only a readjustment of continuing interest in property under modified corporate forms.²³⁴

There is some question as to whose business purpose must be furthered. For example, there may be the business purpose of the shareholders as well as that of the corporations. The Regulations only deal with corporate business purposes. However, recent court decisions do not look exclusively to the corporate business purpose. Instead, they look to all nontax motives involved, those of both corporations and their shareholders.²³⁵

The Revenue Service requires that the parties to a request for a reorganization ruling submit the *business purpose* for the transaction.²³⁶ This statement should outline the logical and sound business considerations and should show that tax considerations, if any, are secondary. Business purposes might include:

1. Expansion,
2. Diversification,

232. *American Wire Fabrics Corp.*, 16 T.C. 607 (1951), *acquiesced in*, 1951-2 CUM. BULL. 1; *Long Island Water Corp.*, 36 T.C. 377 (1961), *acquiesced in*, 1963-1 CUM. BULL. 4. These cases illustrate the interdependence concept in the step transaction doctrine. See note 52 *supra*.

233. 293 U.S. 465 (1935), *aff'd* 69 F.2d 809 (2d Cir. 1934). The opinion of the Court of Appeals for the Second Circuit was written by Judge Learned Hand.

234. Treas. Reg. § 1.368-1(b) (1955) (emphasis added). See also Treas. Reg. § 1.368-1(c) (1955) and the discussion of continuity of interest, above.

235. *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949); *Estate of Parshelsky v. Commissioner*, 303 F.2d 14 (2d Cir. 1962). With the above cases, compare *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947).

236. Rev. Proc. 72-3, 1972 INT. REV. BULL. No. 1, at 9.

3. New sources of materials, parts or products,
4. New distribution channels,
5. Satisfaction of capital,
6. Management or personnel requirements,
7. Financial instability,
8. Substantial economies in operations, and
9. Similar purposes not related to tax avoidance.

TERMINATION OF TAXABLE YEARS

In General. Where there is a B, divisive D or E Type reorganization, the taxable year of the acquired corporation generally remains unchanged. This same rule applies to an F Type reorganization.²³⁷ On the other hand, where there is an A, C, or acquisitive D Type reorganization, the taxable year of any acquired corporation ends on the date of the acquisition.²³⁸ In the case of an A Type statutory consolidation of two or more corporations, a new corporation is created to receive the assets of the predecessors. In such a case, the taxable year of all the predecessors ends on the date of the acquisition.

INHERITED CORPORATE TAX ATTRIBUTES

In General. Section 381(a) of the Internal Revenue Code provides that certain tax attributes set out in the statute pass from the transferor corporation to the acquiring corporation in certain reorganizations. These reorganizations are the A, C, acquisitive D, and F Types.²³⁹ Among the attributes are:

1. Carryforwards such as net operating loss carryforwards,²⁴⁰ capital loss carryforwards,²⁴¹ charitable contribution carryforwards,²⁴² investment credit carryfor-

237. INT. REV. CODE of 1954, § 381(b). If a transaction qualifies as an F Type reorganization and also as another type, it is to be treated only as an F Type. Rev. Rul. 57-276, 1957-1 CUM. BULL. 126. See also Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, amplified by Rev. Rul. 66-284, 1966-2 CUM. BULL. 115. An E Type transaction is not covered by INT. REV. CODE of 1954, § 381. Thus, its taxable year would not be changed. If in a B Type acquisition the acquiring corporation files a consolidated income tax return, the year of the acquired corporation will close on the acquisition date. Treas. Reg. § 1.1502-76(b)(2) (1966). The acquired corporation will then adopt the taxable year of the parent corporation. Treas. Reg. § 1.1502-76(a)(1) (1966).

238. INT. REV. CODE of 1954, § 381(b)(1).

239. INT. REV. CODE of 1954, § 381(a)(2).

240. INT. REV. CODE of 1954, § 381(c)(1).

241. INT. REV. CODE of 1954, § 381(c)(3).

242. INT. REV. CODE of 1954, § 381(c)(19).

wards,²⁴³ work incentive program credit carryforwards,²⁴⁴ and foreign tax credit carryforwards.²⁴⁵

2. Earnings and profits.²⁴⁶
3. Methods of accounting, including inventory valuation, and certain accounting practices and elections²⁴⁷ such as depreciation methods²⁴⁸ and the installment method of reporting gain.²⁴⁹
4. Various other attributes set out in Section 381 of the Internal Revenue Code.

Section 381 does not apply to B, divisive D or E Type reorganizations.

The carryover of these attributes under Section 381 may be very important. In some cases, it may be one of the principal reasons for the acquisition.

Acquiring Corporation. The acquiring corporation in an A, C, acquisitive D, or F Type reorganization is the successor to the enumerated corporate attributes of the transferor. Thus, it is quite important to determine just which corporation is the acquiring corporation. For example, assume Transferee Corporation acquires the assets of Transferor Corporation and then transfers all of them to its controlled subsidiary. Under the Regulations, the acquiring corporation is the corporation which ultimately acquires all of the assets.²⁵⁰ Thus, the controlled subsidiary would be the acquiring corporation. Suppose, however, that Transferee Corporation, instead of assigning all of the assets to its controlled subsidiary, transfers only half of them. Assume further that Transferee Corporation either retains the other half or transfers them to another controlled subsidiary. Under these circumstances, the Regulations provide that Transferee Corporation is considered the acquiring corporation.²⁵¹ Thus, Transferee Corporation may be the acquiring corporation even though it does not retain any of the assets it acquires.

243. INT. REV. CODE of 1954, § 381(c)(23).

244. INT. REV. CODE of 1954, § 381(c)(24).

245. Rev. Rul. 68-350, 1968-2 CUM. BULL. 159. The foreign tax credit is not mentioned in INT. REV. CODE of 1954, § 381. However, Treas. Reg. § 1.381(a)-1(b)(3) (1960) provides that no inference is to be drawn from the fact that an item or attribute is not specifically mentioned in INT. REV. CODE of 1954, § 381.

246. INT. REV. CODE of 1954, § 381(c)(2).

247. INT. REV. CODE of 1954, §§ 381(c)(4) and (5).

248. INT. REV. CODE of 1954, § 381(c)(6).

249. INT. REV. CODE of 1954, § 381(c)(8).

250. Treas. Reg. § 1.381(a)-1(b)(2) (1960).

251. *Id.*

CARRYFORWARDS

In General. The successor corporation in an A, C, acquisitive D, or F Type reorganization is generally entitled to succeed to certain carryforwards of the transferor. They include the net operating loss carryforwards, the capital loss carryforwards, the contribution carryforwards, the investment credit carryforwards, the work incentive program credit carryforwards, and the foreign tax credit carryforwards. However, certain Internal Revenue Code provisions may operate to reduce or disallow the carryforwards.²⁵²

For the first taxable year of the surviving corporation ended after the acquisition, availability of the net operating loss carryforwards of a predecessor is always limited. They are available in this year only to the extent of the taxable income of the successor multiplied by the following factor:²⁵³

252. Rev. Rul. 66-214, 1966-2 CUM. BULL. 98. If the acquisition is a sham transaction, the carryforwards may be disallowed under INT. REV. CODE of 1954, § 482. See *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) and T.I.R. 773, 7 CCH 1965 STAND. FED. TAX REP. ¶ 6751, 6 P-H 1965 FED. TAX SERV. ¶ 55,063. Other sections which might affect the carryforwards are INT. REV. CODE of 1954, §§ 382(b), 383, and 269 together with the rationale of *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), *rehearing denied*, 354 U.S. 943 (1957). INT. REV. CODE of 1954, § 383, applies the rules of § 382(b) to certain carryforwards other than net operating loss carryforwards. They are capital loss carryforwards, investment tax credit carryforwards, work incentive program credit carryforwards, and foreign tax credit carryforwards. INT. REV. CODE of 1954, §§ 381, 382(b) and 383 have no applicability to B, divisive D and E Type reorganizations. For the availability of the foreign tax credit in qualified reorganizations, see note 245 *supra*.

253. INT. REV. CODE of 1954, § 381(c)(1)(B). The capital loss carryforwards would be available generally to the five taxable years succeeding the loss under INT. REV. CODE of 1954, § 1212(a). Under INT. REV. CODE of 1954, § 381(c)(3), the maximum amount which may be carried to the first year of the successor corporation ended after the acquisition is limited. In general, the limitation is the same as that applicable to net operating loss carryforwards. The capital loss rules also apply to foreign expropriation capital losses under INT. REV. CODE of 1954, § 1212. The carryforward for foreign expropriation losses is ten years instead of five years for other capital losses.

The contribution carryforwards are limited under INT. REV. CODE of 1954, § 170(b)(2), to five taxable years succeeding the year of payment. The carryforwards of the transferor may not be utilized until the first taxable year of the successor corporation *beginning* after the acquisition. INT. REV. CODE of 1954, § 381(c)(19).

Investment credits for years ending before 1971 may be carried forward ten years. Those for subsequent years may be carried forward seven years. INT. REV. CODE of 1954, § 46(b)(1). Apparently, these investment credit carryforwards are available to the acquiring corporation without a general proration or disallowance. See INT. REV. CODE of 1954, § 381(d)(23), and Treas. Reg. § 1.46-2(e) (1964). If the acquiring corporation prematurely disposes of transferred property, the acquiring corporation recaptures the investment credit. For purposes of recomputing qualified investment with respect to such property, the useful life begins with the date the transferor placed it in service and ends

Number of days from acquisition to end of year

Number of days in taxable year

In subsequent years the net operating loss carryforwards would be fully available unless they are reduced or eliminated under other provisions of the law or under theories developed by the courts.²⁵⁴ These limitations fall into the following three categories:

1. Sections 382(b) and 383 of the Internal Revenue Code.²⁵⁵
2. Section 269 of the Internal Revenue Code.
3. The *Libson Shops* Theory.²⁵⁶

While a B Type acquisition does not bring the rules of Section 381 of the Internal Revenue Code into play, the availability of the carryforwards of the acquired corporation might be limited under some of the foregoing categories. This discussion of carryforwards is expanded to the extent necessary to cover problems encountered in B Type acquisitions.

Sections 382(b) and 383. Section 382(b) of the Internal Revenue Code applies only to net operating loss carryforwards. However, Section 383 of the Internal Revenue Code makes the same rules applicable to capital loss carryforwards, investment

with the date of disposition by the transferee. See Treas. Reg. § 1.47-3(e)(1) (1967).

The acquiring corporation also succeeds to the work incentive program credits of the transferor. INT. REV. CODE of 1954, §§ 381(c)(24), 40, 50A, and 50B. These credits may be carried forward for seven years under INT. REV. CODE of 1954, § 50A(b)(1). There apparently is no general proration or disallowance of the amount which may be utilized by the successor corporation.

The foreign tax credit carryforward is not mentioned in INT. REV. CODE of 1954, § 381. However, it is considered a corporate tax attribute available to the acquiring corporation. See note 245 *supra*. Foreign tax credits may be carried forward for five years under INT. REV. CODE of 1954, § 904(d).

254. INT. REV. CODE of 1954, § 172(b), provides a five year limitation on net operating loss carryforwards.

255. Under INT. REV. CODE of 1954, § 383, the limitations of § 382(b) dealing with net operating loss carryforwards are extended to certain other carryforwards. They are the capital loss carryforward, the investment credit carryforward, the work incentive program credit carryforward, and the foreign tax credit carryforward. This provision was added by the Revenue Act of 1971, Pub. L. 92-178. The new provision applies to A, C, acquisitive D, and F Type reorganizations occurring after December 10, 1971 under plans of reorganization entered into after September 28, 1971. See the committee reports, 3 CCH 1972 STAND. FED. TAX REP. ¶ 2578A.05 and 2578A.06, 3 P-H 1972 FED. TAX SERV. ¶ 18,565. The foreign tax credit carryforward is available as indicated in note 245 *supra*.

256. This theory results from the Supreme Court decision in *Libson Shops, Inc. v. Koehler*, 353 U.S. 382 (1957), *rehearing denied*, 354 U.S. 943 (1957).

credit carryforwards, work incentive program credit carryforwards, and foreign tax credit carryforwards.

Section 382(b) applies where a corporation acquires assets of another corporation in an A, C, acquisitive D, or F Type reorganization. The carryforwards of the loss company, either transferor or transferee, are reduced if the shareholders of the loss corporation own less than 20 percent of the fair market value of the stock of the survivor.²⁵⁷ The carryforwards are reduced by five percentage points for each percentage point the shareholders of the loss corporation fail to meet the 20 percent value test.²⁵⁸ Thus, for this purpose, there is another continuity of proprietary interest test more stringent than that required for qualifying a reorganization. The provisions of this section are never applicable to B, divisive D, or E Type reorganizations.²⁵⁹

Assume that Parent Corporation owns all of the stock of Surviving Corporation and that Surviving has net operating loss carryforwards. Assume further that Parent is merged into Surviving in an A Type reorganization. This type of merger is commonly referred to as a downstream or downstairs merger. If the fair market value of the assets of Surviving are less than 20 percent of the fair market value of the combined assets of both corporations, it appears that this provision is applicable. Section 382(b) of the Internal Revenue Code does not apply where the transferor and the acquiring corporation are owned substantially by the same persons in the same proportion.²⁶⁰ However, this condition does not appear to be met. Accordingly, the net oper-

257. INT. REV. CODE of 1954, § 382(b). For this purpose, stock means all outstanding shares except nonvoting shares which are limited and preferred as to dividends. INT. REV. CODE of 1954, § 382(c); Treas. Reg. § 1.382(c)-1 (1962). INT. REV. CODE of 1954, § 382(b)(3), provides an exception to this 20 percent limitation where the transferor corporation and the acquiring corporation are owned substantially by the same persons in the same proportion. If after the reorganization the former shareholders of the loss corporation own stock in a corporation controlling the acquiring corporation, this stock is treated as stock of the acquiring corporation at an equivalent market value. INT. REV. CODE of 1954, § 382(b)(6). In *Stockman Nat'l Life Ins. Co. v. U.S.*, 336 F. Supp. 1202 (D. S.D. 1971), the court held the transferor did not have to be liquidated in a C Type acquisition. The Revenue Service sought to deny all net operating loss carryforwards under Treas. Reg. § 1.382(b)-1(a)(2) (1962). This provision of the Regulations requiring a liquidation of the transferor was held invalid.

258. Treas. Reg. § 1.382(b)-1(b)(1) (1962).

259. INT. REV. CODE of 1954, § 381(a)(2). However, see Rev. Rul. 67-274, 1967-2 CUM. BULL. 141, where the Revenue Service ruled that a purported B Type acquisition followed by a liquidation of the acquired corporation was, in substance, a C Type acquisition. This is an excellent example of the step transaction doctrine. See note 52 *supra*.

260. INT. REV. CODE of 1954, § 381(b)(3). See also Rev. Rul. 66-214, 1966-2 CUM. BULL. 98.

ating loss carryforwards of Surviving would appear to be subject to reduction under Section 382(b).²⁶¹

The Senate Finance Committee Report indicates that if a loss is scaled down under Section 382(b), the provisions of Section 269 of the Internal Revenue Code are completely inapplicable.²⁶² The Regulations, however, adopt a contrary position.²⁶³

Section 269. Section 269 of the Internal Revenue Code disallows deductions, credits, or other allowances. However, two conditions must be met. The first condition deals with purpose. The principal purpose of the acquisition must be the evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring person would not otherwise enjoy. The second condition is that the acquisition must fall into one of the following categories:

1. Any person or persons acquire control of a corporation. Control for this purpose is either 50 percent of the total combined voting power of all classes of stock entitled to vote or 50 percent of the total value of shares of all classes of stock.²⁶⁴
2. A corporation acquires property of another which is not controlled immediately before the acquisition by the transferee corporation or its shareholders. In addition, the basis of the acquired property must be determined by reference to its basis in the hand of the transferor. Control for these purposes is also either 50 percent of the total combined voting power of all classes of stock entitled to vote or 50 percent of the total value of shares of all classes of stock.²⁶⁵

A B Type acquisition might be affected under 1, above, assuming the first condition is met. Likewise an A, C, acquisitive D, or F Type reorganization might be affected under 2, above, assuming the first condition is met. This provision would not affect an E Type reorganization as only a single corporation is involved. It would not affect carryforwards under a divisive D Type since the transferee is not entitled to carryforwards of the

261. Treas. Reg. § 1.382(b)-1(d)(2) (1962).

262. S. Rep. No. 1622, 83rd Cong., 2d Sess. 284 (1954).

263. Treas. Reg. § 1.269-6 (1962).

264. INT. REV. CODE of 1954, § 269(a)(1). See also Rev. Rul. 67-202, 1967-1 CUM. BULL. 73. Under this ruling, the same person owned all of the stock of two corporations. He contributed all of the stock of one to the other and the subsidiary was liquidated. The ruling indicated the loss carryforwards of the subsidiary were available to the parent corporation as long as there was a reorganization under INT. REV. CODE of 1954, § 368(a)(1).

265. INT. REV. CODE of 1954, § 269(a)(2). See the discussion of Rev. Rul. 67-202, 1967-1 CUM. BULL. 73, in note 264 *supra*.

transferor. It might, however, affect built-in losses in a divisive D Type transaction. This reorganization might fall under 2, above, assuming the first condition is met.

The first condition deals with the principal purpose of the acquisition. If it was evasion or avoidance of federal income tax by securing the benefit of a deduction, credit, or other allowance which the acquiring person or corporation would not otherwise enjoy, the condition is satisfied. It is well settled that an acquiring corporation enjoys such a benefit even though it involves the tax return of the acquired corporation.²⁶⁶ It also appears well settled that the provision applies to deductions, credits, or allowances economically accrued prior to the acquisition.²⁶⁷ Examples are built-in but unrealized tax losses. Where losses incurred after an acquisition are not built-in losses, they should not be disallowed.²⁶⁸

The provision does not apply unless the *principal* purpose of the acquisition was the evasion or avoidance of income tax. The Senate Finance Committee Report indicates that the prohibited purpose must outrank or exceed in importance any other purpose.²⁶⁹ Where the consideration for an acquisition is disproportionate to the sum of the tax bases of the corporate property acquired and the tax benefit, this is prima facie evidence of the prohibited purpose.²⁷⁰

Generally, courts are somewhat skeptical about arguments that the principal reason for an acquisition was a business pur-

266. *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957), *modifying* 25 T.C. 1304 (1956), *not acquiesced in*, 1956-2 CUM. BULL. 10; *F. C. Publication Liquidating Corp. v. Commissioner*, 304 F.2d 779 (2d Cir. 1962); *Commissioner v. British Motor Car Distributors, Ltd.*, 278 F.2d 392 (9th Cir. 1960), *rev'g* 31 T.C. 437 (1958), *not acquiesced in*, 1959-1 CUM. BULL. 6; *Mill Ridge Coal Co. v. Patterson*, 264 F.2d 713 (5th Cir. 1959), *cert. denied*, 361 U.S. 816 (1959), *rehearing denied*, 363 U.S. 832 (1960).

267. *See* Treas. Reg. § 1.269-2(b) (1962) and cases cited therein. With the regulation, compare *R. P. Collins & Co., Inc. v. United States*, 303 F.2d 142 (1st Cir. 1962).

268. *The Zanesville Investment Co. v. Commissioner*, 335 F.2d 507 (6th Cir. 1964), *rev'g* 38 T.C. 406 (1962).

269. S. Rep. No. 627, 78th Cong., 1st Sess. (1944), 1944 CUM. BULL. 973, at 1017. *See also* Treas. Reg. § 1.269-3 (1962); *Hawaiian Trust Co. Ltd. v. U.S.*, 291 F.2d 761 (9th Cir. 1961); *F. C. Publication Liquidating Corp.*, 36 T.C. 836 (1961), *aff'd on other grounds*, 304 F.2d 779 (2d Cir. 1962); *Goodwyn Crockery Co.*, 37 T.C. 355 (1961), *aff'd on other grounds*, 315 F.2d 110 (6th Cir. 1963). With the above, compare *Malat v. Riddell*, 383 U.S. 569 (1966).

270. INT. REV. CODE OF 1954, § 269(c). *See also* Treas. Reg. § 1.269-5 (1962). This, of course, may be rebutted by evidence to the contrary. In *The Wallace Corp.*, 23 CCH Tax Ct. Mem. 39 (1964), it was stated that *disproportionate* means *less than*.

pose.²⁷¹ The decisions do not lay down any general criteria for determining the principal purpose. However, it is quite clear that any acquisition of a corporate shell or of assets suitable only for liquidation will invite disallowance.

Provision is made for partial availability of deductions, credits, or other allowances.²⁷² The application of this appears indeed to be a rarity.

Libson Shops Theory. The Revenue Service in some situations still follows the judicial doctrine developed in *Libson Shops, Inc. v. Koehler*.²⁷³ This case was decided by the Supreme Court under the Internal Revenue Code of 1939. Sixteen sales corporations were merged into a management corporation. Three had net operating loss carryforwards which the surviving corporation attempted to deduct. Each of the three retail units formerly operated by the three corporations continued to sustain operating losses. The Supreme Court held that, under prior law, the net operating loss carryforwards might be deducted only by the same taxpayer that sustained them. The same taxpayer was involved only to the extent that income was derived from substantially the same business that produced the loss. As a consequence, the Supreme Court did not allow the surviving corporation to deduct the net operating loss carryforwards of the three predecessor loss corporations.

It is questionable whether the *Libson Shops* doctrine is effective under the 1954 Code. The Court of Appeals for the Ninth Circuit²⁷⁴ and the Sixth Circuit²⁷⁵ have indicated that the *Libson Shops* doctrine is not applicable under the 1954 Code. The Court of Appeals for the Fifth Circuit, however, applied the doctrine under the 1954 Code.²⁷⁶ The Revenue Service ruled that

271. See Jeremiah J. O'Donnell, Jr., 23 CCH Tax Ct. Mem. 210 (1964), in which the court apparently used hindsight in disallowing an operating loss carryforward. In this case, O'Donnell offered to purchase either assets or stock of a loss corporation for the same amount. He purchased stock and later transferred a new business to the corporation which disposed of the old business. Approximately two years later, the new business was transferred to a partnership.

272. INT. REV. CODE of 1954, § 269(b).

273. 353 U.S. 382 (1957), *rehearing denied*, 354 U.S. 943 (1957).

274. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965). See comment in *Clarksdale Rubber Co.*, 45 T.C. 234 (1965), *appeal dismissed* (5th and 6th Cir. 1966).

275. *Frederick Steel Co. v. Commissioner*, 375 F.2d 351 (6th Cir. 1967), *cert. denied*, 389 U.S. 901 (1967), *rev'g* 42 T.C. 13 (1964), *acquiesced in result only*, 1966-1 CUM. BULL. 2. With the above, compare *United States v. Jackson Oldsmobile, Inc.*, 371 F.2d 808 (5th Cir. 1967), *aff'g* 237 F. Supp. 779 (M.D. Ga. 1964).

276. *Home Construction Corp. of America v. U.S.*, 439 F.2d 1165 (5th Cir. 1971).

the doctrine is not applicable to A, C, acquisitive D, and F Type reorganizations.²⁷⁷ The doctrine does not apply to a divisive D Type reorganization since no loss carryforwards move to the transferee from the transferor. It does not apply to an E Type transaction since only a single corporation is involved. In Technical Information Release 773, the Revenue Service indicated:

1. The doctrine will be applied where there has been both:
 - a. A 50 percent shift in the benefit of the loss carryforward, and
 - b. Substantially the same trade or business is not continued within the meaning of Section 382(a) of the Internal Revenue Code.
2. The doctrine will *not* be applied where there is either:
 - a. Less than a 50 percent change in the beneficial ownership of the loss carryforward, or
 - b. Substantially the same trade or business has been continued within the meaning of Section 382(a) of the Internal Revenue Code.²⁷⁸

Thus, disallowance of loss carryforwards under the Revenue Service view would apply to a B Type reorganization only if the trade or business is not continued and there has been a 50 percent change of ownership. Under this ruling, the interpretation of substantially the same trade or business within the meaning of Section 382(a) of the Internal Revenue Code may be controlling in many B Type acquisitions.

Section 382(a) of the Internal Revenue Code denies net operating loss carryforwards where two conditions are met. The first is that there must have been a change of 50 percent ownership of a loss corporation. The change must have been a purchase of stock or a decrease in stock outstanding. The second is that the corporation must not have continued to carry on a trade or business substantially the same as that conducted before the change in ownership. Section 382(a) of the Internal Revenue Code has absolutely no applicability to any type of reorganization. Thus, a coverage of its provisions is beyond the scope of this discussion. A review of the provisions regarding change in business would, however, seem in order in view of the Revenue Service position. The Senate Finance Committee Report indicates that a change in business might occur when there has been:

277. Rev. Rul. 58-603, 1958-2 CUM. BULL. 147. See also Rev. Rul. 66-214, 1966-2 CUM. BULL. 98.

278. T.I.R. 773, 7 CCH 1965 STAND. FED. TAX REP. ¶ 6751, 6 P-H 1965 FED. TAX SERV. ¶ 55,063.

1. A shift from one type of business to another,
2. A discontinuance of any, except a minor portion, of its business,
3. A change in location, or
4. Otherwise a failure to carry on substantially the same trade or business.²⁷⁹

The Regulations dealing with a change in the business provide as follows:

In determining whether a corporation has not continued to carry on a trade or business substantially the same as that conducted before any increase in the ownership of its stock, all the facts and circumstances of the particular case shall be taken into account. Among the relevant factors to be taken into account are changes in the corporation's employees, plant, equipment, product, location, customers, and other items which are significant in determining whether there is, or is not, a continuity of the same business enterprise. These factors shall be evaluated in the light of the general objective of Section 382(a) to disallow net operating loss carryovers where there is a purchase of the stock of a corporation and its loss carryovers are used to offset gains of a business unrelated to that which produced the losses.²⁸⁰

The Conference Committee Report indicates that if the old business is continued, a new business might be added.²⁸¹

EARNINGS AND PROFITS²⁸²

In General. The Regulations under Section 381 of the Internal Revenue Code provide a number of intricate rules for the computation of earnings and profits carried over from the transferor to the acquiring corporation. Of these rules, the most important appear to be the following:

1. The accumulated earnings and profits of the transferor when the transaction is consummated become those of the acquiring corporation. These accumulated earnings and profits are not used in computing the earnings and profits of the acquiring corporation for the year in which the acquisition occurs.²⁸³
2. Any deficit in accumulated earnings and profits of the transferor is treated as incurred by the acquiring corpo-

279. S. Rep. No. 1622, 83rd Cong., 2d Sess. 285 (1954).

280. Treas. Reg. § 1.382(a)-1(h)(5) (1962).

281. H.R. Rep. No. 2543, 83rd Cong., 2d Sess. 40 (1954).

282. These rules only apply to A, C, acquisitive D, and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

283. Treas. Reg. § 1.381(c)(2)-1(a)(2) (1961).

ration. It is not, however, used in the computation of the earnings and profits of the acquiring corporation for the year in which the acquisition occurs.²⁸⁴

3. Special rules apply where the transferor corporation has a deficit and the acquiring corporation has accumulated earnings and profits or vice versa. The deficit is maintained in a separate earnings and profits account. It is used to reduce earnings and profits of the acquiring corporation accumulated after the transfer.²⁸⁵
4. If the transferor corporation accumulates earnings and profits or incurs a deficit between the acquisition date and the completion of the reorganization, a special rule applies. The earnings and profits or deficit is deemed to have been accumulated when the property was transferred.²⁸⁶
5. Upon a transfer, special computations usually are necessary. The earnings and profits or deficit of the acquiring corporation must be determined at that time. Ordinarily, this is done on a proration method based on days in the year before and after the acquisition.²⁸⁷

Illustrations of Principles. These provisions may be illustrated by the following example. It is based, in part, on an example in the Regulations.²⁸⁸

Assume Transferor and Transferee Corporations file calendar year income tax returns. On June 30, 1972, Transferor assigns all its assets to Transferee in an A Type reorganization. In addition, assume the following:

<u>Description</u>	<u>Transferor</u>	<u>Transferee</u>
Accumulated earnings and profits at close of calendar year 1971	\$ 20,000	100,000
Deficit in earnings and profits for taxable year ending June 30, 1972	(80,000)	-
Earnings and profits of calendar year 1972	-	73,000
Cash distributions on September 15, 1972	-	<u>96,500</u>

On June 30, 1972, Transferee acquires from Transferor a deficit in accumulated earnings and profits of \$60,000. This deficit may

284. *Id.*

285. Treas. Reg. § 1.381(c)(2)-1(a)(5) (1961).

286. Treas. Reg. § 1.381(c)(2)-1(a)(1) (1961).

287. Treas. Reg. § 1.381(c)(2)-1(a)(6) (1961).

288. Treas. Reg. § 1.381(c)(2)-1(a)(7), example (2) (1961).

be used only to reduce earnings and profits of Transferee which are accumulated or are deemed to have been accumulated after June 30, 1972. On September 15, 1972, Transferee pays a cash dividend of \$96,500: \$73,000 from its earnings and profits for the calendar year 1972 and \$23,500 from its earnings and profits accumulated on December 31, 1971. Accordingly, as of December 31, 1972, Transferee has accumulated earnings and profits of \$76,500 and also a separate deficit of \$60,000. These amounts are determined as follows:

Earnings and profits of Transferee for calendar year 1972	\$ 73,000
Accumulated earnings and profits of Transferee, December 31, 1971	100,000
Total	<u>173,000</u>
Less distributions during 1972	<u>96,500</u>
Accumulated earnings and profits of Transferee, December 31, 1972	<u>\$ 76,500</u>
Deficit in accumulated earnings and profits acquired from Transferor on June 30, 1972	\$(60,000)
Less portion of undistributed earnings and profits of Transferee for 1972 accumulated after June 30, 1972	<u>-0-</u>
Separate deficit in accumulated earnings and profits acquired from Transferee, December 31, 1972	<u><u>\$(60,000)</u></u>

METHOD OF ACCOUNTING

*Overall Method.*²⁸⁹ If the transferor and transferee use the same method of accounting, generally this method must be continued. A different rule may apply where the transferor and transferee use different methods of accounting. The Regulations list three situations where the method of accounting of the transferor carries over to the acquiring corporation.

1. There is no difference in the method of accounting of the transferor and the transferee.²⁹⁰
2. The trade or business of the transferor is operated as a separate and distinct trade or business from that of the acquiring corporation.²⁹¹
3. In an integrated trade or business, the method of ac-

289. These rules only apply to A, C, acquisitive D, and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

290. Treas. Reg. § 1.381(c)(4)-1(b)(1) (1964).

291. Treas. Reg. § 1.381(c)(4)-1(b)(2) (1964).

counting of the transferor carries over if it is the principal method and if it clearly reflects income.²⁹²

The third situation dealing with the integrated trade or business causes the greatest difficulties. The guidelines for determining the principal method of accounting are very complex and sometimes quite vague. Generally, the overall method of accounting is determined by comparing two factors. One is the total of the adjusted bases of the assets immediately before the transfer. The other is the gross receipts for a representative period. Ordinarily, the period is 12 consecutive calendar months preceding the acquisition. The totals are then compared. The principal overall accounting method is the one having both the greatest total assets and the greatest gross receipts. If a member of the integrated trade or business does not have both the greatest total assets and the greatest gross receipts, then there is no principal overall method of accounting. In such a case, the acquiring corporation must request the Revenue Service to determine the appropriate overall method of accounting.²⁹³

*Method for an Item.*²⁹⁴ The principal method of accounting for an item is determined in a manner similar to that for the overall method of accounting.²⁹⁵ The determination is made by comparing the amounts of such item and the related accounts for each trade or business.

The acquiring corporation does not have to renew any election previously made by it or the transferor under the carryforward of the same method of accounting. Also, the acquiring corporation is bound by the elections previously made by the transferor.²⁹⁶

Sometimes the acquiring corporation comes into existence as a result of the reorganization such as, for example, in an A Type consolidation reorganization. It is considered to have adopted the method of accounting employed by the transferors.

If the acquiring corporation wishes to use a method or combination of methods of accounting other than the principal method, it must obtain permission from the Revenue Service to use such other method or methods.²⁹⁷

*Inventories.*²⁹⁸ The provisions of Section 381 of the Internal

292. Treas. Reg. § 1.381(c)(4)-1(b)(3) (1964).

293. Treas. Reg. § 1.381(c)(4)-1(c)(2)(ii) (1964).

294. These rules only apply to A, C, acquisitive D, and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

295. Treas. Reg. § 1.381(c)(4)-1(c)(2)(iii) (1964).

296. Treas. Reg. § 1.381(c)(4)-1(b)(4) (1964).

297. Treas. Reg. § 1.381(c)(4)-1(b)(3) (1964).

298. These rules only apply to A, C, acquisitive D, and F Type reorganizations. INT. REV. CODE of 1954 § 381(c)(2).

Revenue Code were enacted August 16, 1954. Regulations regarding the treatment of inventories were not proposed until December 29, 1960²⁹⁹ and at the date of this writing have not yet been adopted. The provisions of the proposed regulations are quite similar to those discussed above regarding overall methods of accounting.³⁰⁰

*Installment Sales.*³⁰¹ Where the transferor has elected the installment method, the acquiring corporation continues to report on the installment basis.³⁰² Thus, the acquiring corporation must report the income from the installment obligations of the transferor in the same manner and to the same extent as the transferor corporation would have reported them. The only exception is where consent of the Revenue Service is obtained to use another method.³⁰³

*Depreciation.*³⁰⁴ If an acquiring corporation obtains depreciable property from a transferor corporation, the same depreciation method, as a general rule, also must be employed.³⁰⁵ For example, if the transferor used the sum of the years-digits method with respect to an asset, the acquiring corporation must continue to use the sum of the years-digits method.

This rule does not apply to any portion of the basis of the depreciable property which in the hands of the acquiring corporation exceeds the adjusted basis of the transferor. The acquiring corporation may use any reasonable method for computing depre-

299. This is the date the proposed regulations were published in the *Federal Register*.

300. Proposed Treas. Reg. § 1.381(c)(5)-1, 25 Fed. Reg. 13912 (1960). Where the last-in first-out method has been used with respect to a particular type of goods by any party to the reorganization, a special rule may apply. It appears the acquiring corporation may elect this method under Proposed Treas. Reg. § 1.381(c)(5)-1(e)(1), 25 Fed. Reg. 13914 (1960). This may be done without the consent of the Internal Revenue Service and without regard to the principal method of taking inventories. See Mosher, *Treatment of LIFO Inventories in Mergers, Consolidations and Other Nontaxable Acquisitions*, NEW YORK UNIVERSITY 20TH ANNUAL INSTITUTE ON FEDERAL TAXATION 439, 444 (1962).

301. These rules only apply to A, C, acquisitive D and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

302. Treas. Reg. § 1.381(c)(8)-1 (1961).

303. *Id.*

304. These rules apply to A, C, acquisitive D and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

305. Treas. Reg. § 1.381(c)(6)-1 (1961) as amended by TD 7166, 37 Fed. Reg. 5238 (1972). Treas. Reg. § 1.167(a)-11(e)(3) (1971) deals with the asset class life system method of depreciation. If this method was used by a transferor, the acquiring corporation must continue this method for the assets of the transferor unless it obtains the consent of the Revenue Service to change. If the transferor did not use the asset class life system of depreciation, the acquiring corporation may not use this method for depreciating assets obtained in the reorganization unless it secures consent of the Revenue Service.

ciation for such excess which may be used for purchased property previously used by another.³⁰⁶

OTHER CORPORATE ATTRIBUTES

*In General.*³⁰⁷ Section 381 of the Internal Revenue Code has provisions covering certain other corporate attributes. They are as follows.

Attribute	Provisions Applicable Thereto	
	Internal Revenue Code Section 381(c)	Income Tax Regulations Section 1.381(c)
Amortization of Bond Premium	(9)	(9)-1
Deferred Development and Exploration Expenses in the Case of Mines	(10)	(10)-1
Deductions under Section 404 of the Internal Revenue Code for Deferred Compensation Plans	(11)	(11)-1
Recovery of Bad Debts, Prior Taxes, or Delinquency Amounts	(12)	(12)-1
Involuntary Conversions	(13)	(13)-1
Personal Holding Company Dividend Carryforward	(14)	(14)-1
Personal Holding Company Indebtedness	(15)	(15)-1
Certain Obligations of Transferor Corporation Giving Rise to Later Deduction	(16)	(16)-1
Personal Holding Company Deficiency Dividends	(17)	(17)-1
Percentage Depletion from Waste or Residue of Prior Mining	(18)	(18)-1
Pre-1954 Adjustments Resulting from Change in Method of Accounting	(21)	(21)-1
Successor Life Insurance Company	(22)	(22)-1

A coverage of these items is beyond the scope of this discussion.

CONCLUSION

This discussion has presented some of the problems which may be encountered in corporate reorganizations. In these transactions the determination of the tax results may be insured by a

306. Treas. Reg. § 1.381(c)(6)-1(b) (1961), *as amended* by TD 7166, 37 Fed. Reg. 5238 (1972). The use of the double declining balance method, sum of the years-digits method and similar accelerated methods is restricted. Among other things, they may be used only for property when the original use commences with the acquiring corporation. INT. REV. CODE of 1954, § 167(c).

307. These rules only apply to A, C, acquisitive D, and F Type reorganizations. INT. REV. CODE of 1954, § 381(c)(2).

knowledge of current developments, counsel of tax advisers, and a considerable amount of good luck. This is a field where changes in interpretation of the statute are the hallmark.

Perhaps the best advice is that one should keep his six letter alphabet straight or he not only will be in the soup but reorganization alphabet soup as well. In fact, the soup might be comparable to the brew of the three witches in *Macbeth* where the witches chanted:

Double, double toil and trouble;
Fire burn and caldron bubble.³⁰⁸

308. W. Shakespeare, *MACBETH*, Act IV, Scene I.