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Federalizing the Tax-Free Merger: Toward an End to the Anachronistic Reliance on State Corporation Laws

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FEDERALIZING THE TAX-FREE MERGER: TOWARD AN END TO THE ANACHRONISTIC RELIANCE ON STATE CORPORATION LAWS

STEVEN A. BANK*

This Article examines the requirement that a merger be "statutory," or conducted pursuant to the corporation laws of a state, to be tax-free. Tl'he statutory merger requirement for "A" reorganizations is an anachronistic remnant of the 1930s belief that state corporation laws are effective regulators of corporate combinations and bulwarks against abuse of the tax-free reorganization provisions. This reliance on state corporate law standards is not only inconsistent with the recently adopted check-the-box regulations and no longer an adequate regulator, but is also counterproductive in that it introduces disparities of treatment between parties based on their location. Ironically, the statutory merger requirement could conceivably prevent de facto mergers and mergers involving single-member limited liability companies, but permit mergers under nouveau corporate law statutes that do not require the parties to "merge" under any conventional sense of the word. Form is elevated above substance. In light of the failed efforts to remove the A reorganization from the Internal Revenue Code altogether, this Article concludes that the statutory merger requirement should be eliminated from the A reorganization so that a more uniform standard can be applied by the courts and the Internal Revenue Service.

INTRODUCTION 1308
I. THE DEVELOPMENT AND DECLINE OF THE STATUTORY MERGER REQUIREMENT 1314
A. *Early History of the Reorganization Provisions* 1314

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1. 1913-1921 1314
2. 1921-1934 1331
B. 1934 and the Institution of a Statutory Merger Requirement 1342
1. Use of State Corporation Laws to Protect Against Abuse 1342
2. Limit Excessive Business Combinations in Response to the 1929 Stock Market Crash 1352
3. Expansion to Include Other Forms of Reorganizations 1354
C. The Judicial Evisceration of the Statutory Merger Requirement 1358
II. THE CASE FOR REMOVING THE STATUTORY MERGER REQUIREMENT 1364
A. The Statutory Merger Requirement Is at Cross-Purposes with the New Check-the-Box Regulations 1364
B. State Corporation Laws Have Become Increasingly Poor Gatekeepers 1373
1. Generally 1373
2. Over-Inclusive—The Texas Example 1375
3. Under-Inclusive 1384
a. De Facto Mergers 1385
b. State Reorganization Statutes: The California Example 1386
III. OPTIONS FOR FEDERALIZING THE TAX-FREE MERGER 1389
A. Redraft Section 368(a)(1)(A) to Include Certain Common Law Requirements 1390
B. Remove the A Reorganzation from the Code Altogether 1392
C. Leave the Definition to the IRS and the Courts 1396
CONCLUSION 1401

INTRODUCTION

For over eighty years, Congress has permitted taxpayers to defer the recognition of income realized on the receipt of stock or other securities in certain types of business combinations and readjustments.[1] As currently described in the Internal Revenue

1. The federal tax system is structured so that gains or losses on property held by taxpayers are not "recognized," and therefore not taxed or deducted, until those gains or losses are "realized" through a tax-triggering transaction such as a sale or other disposition. Even realized gains or losses may be deferred pursuant to specific statutory nonrecognition rules. They are deferred rather than waived completely through an

Code,[2] participants in transactions qualifying under one of the defined categories of "reorganizations" under section 368 of the Code are eligible for nonrecognition treatment. These defined categories include the following acquisitive reorganizations:[3] (1) an "A" reorganization, or a "statutory" merger or consolidation in which a merger or consolidation is conducted "pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia";[4] (2) a "B" reorganization, or a stock-for-stock reorganization involving "the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . , of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation";[5] and (3) a "C" reorganization, or a stock-for-assets reorganization involving

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adjustment to the taxpayer's basis in the property that requires the recognition of the full amount of gain or loss upon the occurrence of a realization event not exempted by a nonrecognition provision. *See* I.R.C. §§ 61(a)(3), 1001 (West Supp. 1998); Eisner v. Macomber, 252 U.S. 189, 207 (1920). Thus, a mere change in value of property is generally not subject to taxation. *But see* I.R.C. § 475 (West Supp. 1998) (imposing mark-to-market treatment on dealers in securities with respect to their securities held as inventory); *id.* § 817A (West Supp. 1998) (mandating mark-to-market treatment for segregated accounts held by life insurance companies as modified guaranteed contracts); *id.* § 1256 (1994) (mandating mark-to-market treatment for certain contracts); *id.* § 1296 (West Supp. Oct. 1998) (permitting a taxpayer to elect mark-to-market treatment for marketable stock in a passive foreign investment company).

2. Unless otherwise specified, all references to the Internal Revenue Code (the "Code") mean the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

3. Non-acquisitive reorganizations (or reorganizations for which the primary purpose is not acquisitive) include: (1) a "D" reorganization under § 368(a)(1)(D), or a transfer of assets to a controlled corporation in connection with another reorganization or a spin-off under § 355; (2) an "E" reorganization under § 368(a)(1)(E), or a recapitalization; (3) an "F" reorganization under § 368(a)(1)(F), or a mere change in identity, form, or place of organization of one corporation; and (4) a "G" reorganization under § 368(a)(1)(G), or a bankruptcy reorganization. *See* I.R.C. § 368(a)(1) (West Supp. 1998).

4. *Id.* § 368(a)(1)(A); Treas. Reg. § 1.368-2(b)(1) (1998). The IRS has officially taken the position that the A reorganization is not available for mergers between domestic and foreign corporations. *See* Rev. Rul. 57-465, 1957-2 C.B. 250; BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 12.22, at 12-41 & n.75 (6th ed. 1994); James M. Lynch, *Back to the Code: A Reexamination of the Continuity Doctrines and Other Current Issues in Reorganizations*, 73 TAXES 731, 742 (1995). A reverse subsidiary merger, in which the target corporation's shareholders in a statutory merger receive stock of a corporation controlling the merged corporation in exchange for their target corporation stock, also qualifies as a form of A reorganization, but it is subject to the additional requirements that the surviving corporation retain "substantially all of its properties" and that the former target corporation's shareholders exchange an amount of stock constituting "control" under § 368(c). I.R.C. § 368(a)(2)(E) (West Supp. 1998).

5. I.R.C. § 368(a)(1)(B).

"the acquisition by one corporation, in exchange solely for all or part of its voting stock ..., of substantially all of the properties of another corporation."[6] In addition, all such reorganizations are subject to the judicially imposed requirements that the target shareholders maintain sufficient continuity of interest in the business in its modified corporate form, that the acquirer continue to conduct the target's business enterprise after the acquisition, and that the transaction have a business purpose.[7]

For most of these eighty years, the Code's failure to apply a uniform tax standard for all reorganizations has been widely criticized as arbitrary, complex, and overly formalistic.[8] This criticism appears to be faithful to some of the original concerns of the legislative drafters because the Code defines a number of economically similar transactions as "reorganizations" so that the same tax consequences should be applied to each.[9] As Professor Stanley Surrey noted in an American Law Institute Tax Project Study of the reorganization provisions, "there do not appear to be any reasons for differences in tax rules simply because one or the other method is chosen for non-tax reasons."[10] An American Bar

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6. *Id.* § 368(a)(1)(C). A forward subsidiary merger, in which a corporation acquires substantially all of the properties of another corporation in exchange for the stock of the acquirer's parent corporation, is a form of A reorganization, although it has many of the characteristics of a C reorganization. *See id.* § 368(a)(2)(D).

7. *See, e.g.*, 1 MARTIN D. GINSBURG & JACK S. LEVIN, MERGERS, ACQUISITIONS, AND BUYOUTS §§ 609-611 (1998) (citing Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (continuity of interest), and Gregory v. Helvering, 293 U.S. 465 (1935) (business purpose)); Peter L. Faber, *Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?*, 34 TAX LAW. 239, 269 (1981) (citing Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) (continuity of business enterprise)). The Treasury Regulations now explicitly impose these judicially created doctrines. *See* Treas. Reg. § 1.368-1(c) (1998) (business purpose); *id.* § 1.368-1(d) (continuity of business enterprise); *id.* § 1.368-1(e) (continuity of interest).

8. *See, e.g.*, AMERICAN LAW INST., FEDERAL INCOME TAX PROJECT: SUBCHAPTER C 155 (1982); RANDOLPH E. PAUL, STUDIES IN FEDERAL TAXATION: THIRD SERIES 3 (1940). Professor Calvin Johnson said of the "substantially all" properties requirement of C reorganizations: "The disparity is hard to defend ... as a matter of policy. If the rule is one of fundamental principle, why does not it apply to all reorganizations? If the rule is trivial or perverse, why apply it to any?" Calvin H. Johnson, *A Full and Faithful Marriage: The Substantially-All-The-Properties Requirement in a Corporate Reorganization*, 50 TAX LAW. 319, 355 (1997).

9. *See* Valentine Brookes, *The Continuity of Interest Test in Reorganizations—A Blessing or a Curse*, 34 CAL. L. REV. 1, 25 (1946).

10. Stanley S. Surrey, *Income Tax Problems of Corporations and Shareholders: American Law Institute Tax Project—American Bar Association Committee Study on Legislative Revision*, 14 TAX L. REV. 1, 20 (1958). The focus on the evils of disparate treatment is not limited to the reorganization provisions. Disparate treatment was a major impetus in the recent revision of § 1234A to treat as capital any gain or loss attributable to

Association Committee concluded that these different requirements "frequently induce corporations to restructure their transactions (often in convoluted fashion) to fit within particular statutory definitions while business and economic realities remain unchanged."[11] Because of the concern over disparate treatment, many proposals to collapse the various types of reorganizations and requirements have been submitted over the years,[12] but no wholesale changes have been made.[13]

What reformers have ignored in their quest to rid the overall system of disparity, however, is that an even more arbitrary and formalistic disparity exists within "the oldest of, and the prototype for, the various reorganization forms"—the A reorganization.[14] Under the A reorganization's statutory merger requirement,[15] economically and substantively identical transactions are treated differently not because of Congress's decision to apply a different set of requirements, but merely because of differences in state corporation laws.[16]

The statutory merger requirement is an anachronism from a period when state corporation laws were thought to be more significant regulators of corporate activity.[17] Mergers and

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the cancellation, lapse, expiration, or other termination of a right or obligation with respect to non-actively traded as well as actively traded personal property. *See* STAFF OF JOINT COMM. ON TAXATION, 105TH CONG., GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at 188 (Joint Comm. Print 1997).

11. Committee on Corporate Stockholder Relationships, *Tax Section Recommendation No. 1981-5*, 34 TAX LAW. 1386, 1394 (1981).

12. *See, e.g.*, STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., FINAL REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985, at 3 (Comm. Print 1985); Committee on Corporate Stockholder Relationships, *supra* note 11, at 1386; Surrey, *supra* note 10, at 20.

13. In part, this is because such proposals have attempted to substitute a new complex system for a system that has as its most commendable quality its general familiarity to practitioners. *See* Daniel Q. Posin, *A Case Study in Income Tax Complexity: The Type A Reorganization*, 47 OHIO ST. L.J. 627, 668 (1986).

14. BITTKER & EUSTICE, *supra* note 4, ¶ 12.22, at 12-41.

15. Consolidations are relatively rare among modern business transactions. Therefore, this Article will refer to the requirement that mergers or consolidations be statutory as the "statutory merger requirement."

16. Although the Treasury Regulations refer to "the corporation laws of the United States or a State or territory, or the District of Columbia," Treas. Reg. § 1.368-2(b)(1) (1998), few corporations are organized under anything but state law, and therefore few mergers will be subject to anything other than state corporation law, *see* Posin, *supra* note 13, at 631.

17. State corporate law is generally defined as the universe of statutory and judge-made doctrines that govern the operation of corporations and the rights of their shareholders and other constituencies. *See, e.g.*, David Millon, *Default Rules, Wealth Distribution, and Corporate Law Reform: Employment at Will Versus Job Security*, 146 U. PA. L. REV. 975, 978 (1998). In this context, it is likely that the Treasury regulations'

consolidations were made tax-free in 1918 to remove bars to business transactions in the rapidly developing equity markets and to codify the belief that the exchange of stock in one company for the stock of a combined venture was not an appropriate time to measure the realization of income.[18] Nonrecognition treatment was soon expanded to cover merger-like transactions, but by the 1930s, loose draftsmanship and clever advisors combined with the general anti-merger sentiment following the stock market crash of 1929 to raise the specter of tax avoidance to an unacceptable level. Amid proposals to remove the tax-free reorganization provisions from the Code altogether, an implicit compromise was struck in 1934.[19] Congress added the statutory merger requirement to tie the merger provision more closely to the protections imposed by state corporation laws, and courts imposed the judicially created doctrines of continuity of interest and business enterprise on transactions claiming to qualify for the non-merger reorganization provisions.[20] Policymakers believed that mergers conducted pursuant to state law were subject to many limitations, including an automatic continuity of shareholder interest and a protection of dissenters and creditors, the aggregate effect of which would be to ensure that the aims of the reorganization provisions were achieved. Thus, Congress did not subject statutory mergers to the same restrictions that were imposed on transactions that only resembled mergers or consolidations.[21] Eventually, however, courts imposed the continuity of interest requirement on statutory mergers on the theory that Congress had not bound itself to the vagaries of state law in determining reorganization status.[22] This effectively gutted the statutory merger of any safe harbor protection it may have provided to participants, but the requirement continued to exist as a theoretical guard against abuse. Critics complained that the statutory merger requirement resulted in unequal treatment based on the location of a transaction, but the advent of more uniform state corporate laws helped to ease their fears.[23]

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reference to state corporate law is meant to include judicial interpretations of statutory provisions, rather than doctrines such as the de facto merger that are a wholly judicial invention in most states. Otherwise, those regulations would delimit the meaning of the "statutory" reference in the Code.

18. *See infra* Part I.B.1-2.
19. *See infra* Part I.B.3.
20. *See infra* Part I.B.1-3.
21. *See infra* Part I.C.
22. *See infra* Part I.C.
23. *See infra* Part I.C.

Recent developments in state corporation law and federal tax law have exacerbated the disparities in treatment for parties seeking A reorganization status and have obliterated any notion that state corporation laws continue to provide a check against tax avoidance. The adoption of the new check-the-box regulations, which de-emphasize the Code's reliance on state corporation law and permit single-member limited liability companies to elect to be treated as divisions of their parent,[24] has the ironic potential to magnify the disparity caused by the A reorganization's reliance on state corporation laws. Because an acquiring corporation need not directly assume the liabilities of its target under state law,[25] a single member limited liability company eliminates one obstacle to the use of the A reorganization. The statutory merger requirement, however, may limit tax-free treatment for such a deserving merger when the state corporation laws do not provide for the merger of corporate and non-corporate entities or do not recognize the existence of single member limited liability companies. Moreover, as a gatekeeper, the reliance on state corporation laws for the determination of whether a transaction qualifies as an A reorganization has become both over- and under-inclusive. The reliance on state corporation laws is over-inclusive because the advent of increasingly liberal state corporation laws has moved the concept of a merger or consolidation farther and farther from the common law definitions. While it has long been apparent that the statutory merger requirement cannot be depended upon to prevent an abuse of the reorganization provisions, a state merger statute that permits a sale to be classified as a merger turns the A reorganization provision on its head. The reliance on state corporation laws also is under-inclusive because it is difficult to justify the exclusion of statutory transactions that are not defined as mergers, but provide many of the shareholder and creditor protections originally used to justify nonrecognition treatment for reorganizations. These developments highlight the need to focus on the disparity and inequity that is caused by the continued reliance on the statutory merger requirement for A reorganizations.

This Article argues that a merger's eligibility for A reorganization treatment should not depend upon whether it has satisfied the requirements imposed by a state's corporation laws. Part I, which sets forth the history and development of the reorganization provisions and the advent of the statutory merger

24. *See* Treas. Reg. § 301.7701-3(b) (1998).

25. *See* 1 GINSBURG & LEVIN, *supra* note 7, § 801.6.

requirement, explains why the requirement has become an anachronism. Part II discusses the developments in both state corporation law and federal tax law that have magnified the problems caused by the continued presence of the statutory merger requirement. Part III argues that eliminating the statutory merger requirement is both a feasible and preferable alternative to the current classification system for A reorganizations. Finally, Part IV concludes by offering a brief perspective on the merits of this proposal amid the defeat of more comprehensive efforts to integrate the taxation of corporate and shareholder income taxes.

I. THE DEVELOPMENT AND DECLINE OF THE STATUTORY MERGER REQUIREMENT

A. *Early History of the Reorganization Provisions*

1. 1913-1921

When the first post-Sixteenth Amendment income tax was enacted as part of the Underwood/Simmons Tariff Act in 1913,[26] it was assumed that Congress had the power to tax reorganization exchanges but chose not to do so.[27] The 1913 Act contained no special provisions for the exemption of gain or loss in mergers, consolidations, or reorganizations, and no provisions were added in the 1916 or 1917 Revenue Acts.[28] Administrative guidance, while somewhat more revealing than the Revenue Acts themselves, did little to develop a definitive position on the tax treatment of such transactions. Some practitioners contended that reorganizations, mergers, and consolidations created little more than a nontaxable stock dividend for the shareholders of the constituent corporations.[29] Early pro-taxpayer rulings by the Treasury Department seemed to agree with the practical effect of such contentions,[30] but regulations

26. Tariff Act of 1913, ch.16, 38 Stat. 114. For a history of the use of the income tax in this country prior to the adoption of the Sixteenth Amendment, see Steven A. Bank, *Origins of a Flat Tax*, 73 DENV. U. L. REV. 329 (1996).

27. *See* David F. Shores, *Reexamining Continuity of Shareholder Interest in Corporate Reorganizations*, 17 VA. TAX REV. 419, 440 (1998).

28. *See* PAUL, *supra* note 8, at 8; Homer Hendricks, *Federal Income Tax: Definition of "Reorganization,"* 45 HARV. L. REV. 648, 648 n.1 (1932); Hugh Satterlee, *The Income Tax Definition of Reorganization*, 12 TAX MAG. 639, 639 (1934).

29. *See* 11 MERTENS LAW OF FEDERAL INCOME TAXATION § 43.02 (1990) [hereinafter MERTENS].

30. The Treasury Department issued a private letter ruling in 1917 that came to the following conclusion:

issued in 1918 pursuant to the 1916 Act provided that exchanges of property for stock might result in taxable income in certain circumstances.[31] It was not until the summer of 1918 that it became clear that Congress would resolve the uncertainty through legislative enactment.[32]

Three developments brought the issue to the forefront: (1) the extension of stock ownership from the privileged few to a much broader base of the population; (2) the post-World War I boom in mergers and acquisitions activity; and (3) the significant increase in taxes imposed under a new Revenue Act adopted in 1917. These developments combined to raise the stakes for more people on the question of how to treat mergers and acquisitions for federal income tax purposes.

First, the rise in participation in equity markets after the onset of World War I considerably broadened the base of people and corporations potentially subject to tax in a merger, consolidation, or other reorganization. During most of the nineteenth century, the largest corporations were private, family-controlled enterprises, and the few manufacturing company stocks that were publicly traded were not widely held.[33] The New York Stock Exchange, originating in 1792 and emerging in its modern form in 1869,[34] experienced its most substantial growth after the merger movement of the mid-1890s, gradually replacing a system for raising capital through private

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> Where upon a reorganization stock of the new company was issued in exchange for shares of the old, the new company taking over the property of the old, no income accrued if the exchange of stock was share for share of like par value, even though the property of the first corporation had increased in value over a period of years since its stock was first issued.

GEORGE E. HOLMES, FEDERAL INCOME AND PROFITS TAXES 262 n.20 (1920) (citing Letter from Treasury Dep't, Mar. 8, 1917; I.T.S. 1918, ¶ 1302); *see also* GEORGE E. HOLMES, FEDERAL INCOME TAX 670 n.94 (6th ed. 1925) (citing two 1915 letter rulings to the same effect); Shores, *supra* note 27, at 441 n.69 (citing Letter from Treasury Dep't, Mar. 8, 1917; I.T.S. 1918, ¶ 1302).

31. *See* PAUL, *supra* note 8, at 8 (citing Treas. Reg. 33 (Revised), arts. 101, 118, 119 (1918), *reprinted in* 132 U.S. REVENUE ACTS 1909-1950, at 60, 65-66 (Bernard D. Reams, Jr. ed., 1979) [hereinafter U.S. REVENUE ACTS]; Daniel Q. Posin, *Taxing Corporate Reorganizations: Purging Penelope's Web*, 133 U. PA. L. REV. 1335, 1340 (1985).

32. Of course, even this resolution left pre-1918 reorganizations to the uncertainties of the administrative and judicial process. *See, e.g.*, A.R.R. 156, 2 C.B. 39, 40-41 (1920) (refusing to apply the 1918 Act reorganization provision to a transaction that took place in 1915).

33. *See* JONATHAN BARRON BASKIN & PAUL J. MIRANTI, JR., A HISTORY OF CORPORATE FINANCE 193 (1997); ROBERT SOBEL, INSIDE WALL STREET 32 (1977).

34. *See* SOBEL, *supra* note 33, at 26-27; Stuart Banner, *The Origin of the New York Stock Exchange, 1791-1860*, 27 J. LEGAL STUD. 113, 115 (1998).

subscriptions with one that relied on publicly traded shares of stock.[35] Shares traded on the Exchange jumped from 57 million in 1896 to 260 million in 1907.[36] This rise in the volume of shares traded eventually broadened the base of individuals participating in equity markets. Individuals holding shares of common stock in corporations increased four-fold during the first two decades of the twentieth century, from a half-million to two million.[37] In part, the sale of Liberty Bonds during World War I helped to introduce a whole new generation and socioeconomic class of people to the world of securities and the stock market.[38] The growth of financial intermediaries, such as banks and brokerage houses that offered both underwriting services to take companies public and investment advisory services to push the sales of those new issues, further facilitated the development of a mass market for common stocks.[39] With this increase in the number of corporations offering public shares and in the number of individuals holding such shares, the tax treatment of reorganizations became a question of immediate concern for a larger segment of society than it had ever been before.

Second, the increase in mergers and acquisitions after World War I brought the uncertainty of the tax consequences to the forefront of the minds of corporations and their newly enlarged

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35. *See* MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY 95 (1992); *see also* MARTIN J. SKLAR, THE CORPORATE RECONSTRUCTION OF AMERICAN CAPITALISM, 1890-1916, at 4 & n.1 (1988) (describing the transition from closely held to publicly held corporations).

36. *See* HORWITZ, *supra* note 35, at 95. Symbolic of this change in the stature of public trading, the New York Stock Exchange constructed a massive new facility between 1901 and 1903 at a price tag of more than $4 million. *See* SOBEL, *supra* note 33, at 45-46.

37. *See* BASKIN & MIRANTI, *supra* note 33, at 190; *see also* SOBEL, *supra* note 33, at 101 ("Prior to World War I, probably less than one hundred thousand Americans owned securities in firms listed on the N.Y.S.E. By the late 1920s, there were over three million shareholders . . . .").

38. *See* 1 LOUIS LOSS, SECURITIES REGULATION 114-15 (2d ed. 1961); SOBEL, *supra* note 33, at 203 ("Individuals who prior to 1917 had savings accounts, some property, and considered all stocks and bonds esoterica, now had experiences in dealing with investment bankers, and learned that they could increase the yields on their savings through the purchase of bonds—and possibly stocks."); CAROLYN WEBBER & AARON WILDAVSKY, A HISTORY OF TAXATION AND EXPENDITURE IN THE WESTERN WORLD 442 (1986).

39. *See* 1 LOSS, *supra* note 38, at 164-65, 196; *see also* J. KEITH BUTTERS ET AL., EFFECTS OF TAXATION: CORPORATE MERGERS 310-11 (1951) (discussing the distinction between earlier and more recent merger trends, including the role played by investment bankers). The potential conflict of interest between the two activities was part of the concern that prompted Congress to separate commercial banks from investment banks in the Banking Act of 1933—more commonly referred to as the Glass-Steagall Act. *See* Banking Act of 1933, ch. 89, 48 Stat. 162 (codified as amended in scattered sections of 12 U.S.C.); Investment Co. Inst. v. Camp, 401 U.S. 617, 630, 633 (1971).

group of shareholders. Although the merger device enjoyed some popularity prior to the Civil War,[40] it was first relied on by large segments of business at the turn of the century.[41] Businesses turned to corporation law for refuge in response to judicial and legislative efforts to slow the growth of trusts and other combinations in restraint of trade. As Arthur Eddy explained in 1901, "while the courts might deny the rights of individuals, firms or corporations to meet together and form associations, pools or agreements with the intent to control prices and outputs, no court would deny the right of an individual, or of a partnership, or of a corporation" to actually buy the assets or business as a whole of another corporation.[42] Aided further by the liberalization of state corporation laws to permit majority rather than unanimous shareholder approval of mergers and consolidations, mergers were at an all-time high between 1898 and 1903.[43] By 1908, the total capitalization of business combinations was $31 billion, almost nine times larger than in 1900.[44] Notwithstanding these numbers and the vast size of the corporations created in industries such as oil and steel during the turn-of-the-century merger movement,[45] the post-war boom was in many ways more significant. By 1920, business combinations were occurring at a more frequent clip than at any time during the earlier period.[46] As with the rapid development of the securities market itself, the merger movement was fostered in part by the development of the investment banking industry. One commentator noted that "[s]ince the commissions

40. *See* Comment, *Statutory Merger and Consolidation of Corporations*, 45 YALE L.J. 105, 106 n.2 (1935). One commentator wrote that the utility of the merger device was first noticed during the development of interstate methods of transportation by means of turnpikes and other toll roads. As two roads in separate states became physically joined, it made sense for the separate corporations operating such roads to be joined as well. *See* Eldon Bisbee, *Consolidation and Merger*, 6 N.Y.U. L. REV. 404, 404-05 (1929); *see also* Nelson Ferebee Taylor, *Evolution of Corporate Combination Law: Policy Issues and Constitutional Questions*, 76 N.C. L. REV. 687, 746 (1998) (describing the same phenomenon in the railroad industry).

41. *See* BUTTERS ET AL., *supra* note 39, at 287-88.

42. 1 ARTHUR J. EDDY, THE LAW OF COMBINATIONS 601 (1901), *reprinted in* HORWITZ, *supra* note 35, at 87.

43. *See* HORWITZ, *supra* note 35, at 87-89; Marjorie E. Kornhauser, *Corporate Regulation and the Origins of the Corporate Income Tax*, 66 IND. L.J. 53, 56 (1990). By the end of the merger movement, over 300 mergers, having an aggregate capitalization of approximately $7 billion, had occurred. *See* BUTTERS ET AL., *supra* note 39, at 288; SKLAR, *supra* note 35, at 46.

44. *See* FREDERICK LEWIS ALLEN, THE LORDS OF CREATION 162 (1935).

45. The Standard Oil Trust was created in 1879 and the billion-dollar United States Steel Corporation was created in 1901. *See* BUTTERS ET AL., *supra* note 39, at 287-88.

46. *See id.* at 292; Conway L. Lackman, *Effect of Taxes on Business Mergers*, 23 ANTITRUST BULL. 551, 556 (1978).

received by investment bankers and other financiers for the flotation of combinations were often very large, it seems probable that their pursuit of financial profit was at least a contributing cause of the formation of many mergers."[47] This increase in the number of mergers so soon after the adoption of the income tax magnified the importance of resolving the taxability of such transactions.[48]

Finally, both the rise in income tax rates and the addition of an excess profits tax in the 1917 Act increased the economic stakes for those involved in the new round of reorganizations and prompted a rapid influx of inquiries in Congress.[49] After corporate and individual normal and surtax rates doubled in 1916 due to wartime expenditures, Congress in 1917 sought to raise additional revenues through a significant increase in individual and corporate taxes and a cut in personal exemptions.[50] The House Ways and Means Committee proposed, in addition to a war excess-profits tax,[51] an increase in taxes that would yield, during a 12-month period, approximately $161 million in additional revenues from corporations and $372 million in additional revenues from individuals.[52] The Senate sought an increase in these numbers, especially as they concerned corporations and corporate profits. According to a Senate Finance Committee Report on the proposed bill, the increase in taxes "was not an unreasonable additional amount to ask from the industries whose earnings have been so greatly augmented by the conditions which made necessary the call for this additional

47. Joe S. Bain, *Industrial Concentration and Government Anti-Trust Policy*, *in* THE GROWTH OF THE AMERICAN ECONOMY 711 (Harold F. Williamson ed., 1944).

48. *See* Posin, *supra* note 31, at 1347 ("Given the size of these transactions, and the large number of taxpayers holding stock in General Motors and the other large corporations involved, the lack of predictability in these cases was unacceptable.").

49. *See* PAUL, *supra* note 8, at 9 (noting that the increase in income tax rates "precipitated a flood of inquiries" on corporate reorganizations); Saterlee, *supra* note 28, at 639 ("The subject first became of widespread interest because of the high rates under the 1917 Act, and in the spring of 1918 was studied in the office of the Solicitor of Internal Revenue as an original problem.").

50. *See* ROY G. BLAKEY & GLADYS C. BLAKEY, THE FEDERAL INCOME TAX 153 (1940). Maximum income tax rates rose from 15% in 1916 to 67% in 1917 and 77% in 1918 in part because war expenditures caused government spending to rise from 1.8% of gross national product in 1913 to 21% in 1917 and 24.1% in 1918. *See* WEBBER & WILDAVSKY, *supra* note 38, at 422, 441; *see also* Arthur A. Ballantine, *Corporate Personality in Income Taxation*, 34 HARV. L. REV. 573, 578 (1921) (calling the 1917 Act a "radical change" in the tax system).

51. "Excess" profits were profits in excess of a reasonable return on invested capital. Such taxes were enacted under the theory that businesses should not be permitted to keep certain extraordinary profits caused by wartime expenditures. *See* WEBBER & WILDAVSKY, *supra* note 38, at 422.

52. *See* H.R. REP. NO. 65-45, at 3 (1917), *reprinted in* 1939-1 C.B. (pt. 2), at 48, 49.

revenue."[53] Thus, the Senate proposed a war profits tax that would raise an additional $562 million in revenue.[54] Furthermore, individual rates were drastically increased by the Senate amendments to the House bill. For example, under the new rates as finally adopted, married individuals making $100,000 who were taxed at a rate of 3.92% prior to 1917 were taxed at a rate of 15.63% as a result of the 1917 Act.[55] Married individuals with incomes of $1,000,000 saw their rates jump from 10.29% to 40.86% as a result of the Act.[56] Perhaps most significantly, the 1917 Act lowered the threshold for imposition of higher rates from $20,000 to $5000, a drop that significantly expanded the reach of the increased taxes.[57] Ultimately, aggregate taxes per capita increased over 300% during the war—from $23 in 1913 to $75 in 1919—and individual rates reached a maximum of 77% by 1918.[58] The 1917 Act itself was considered "the greatest burden that had ever been laid upon the American people."[59] According to Randolph Paul, the enactment of the higher taxes in 1917 "precipitated a flood of inquiries on the subject of corporate reorganizations ... [under] the belief that the reorganization provisions were more a necessity than a luxury."[60] Although the problem of taxes to shareholders in corporate reorganizations was still one reserved for the upper economic strata of society, that strata was growing and diversifying because of the spread of security holders and the increase in the number of reorganizations.

Supporters of a provision for the nonrecognition of gains realized in reorganizations, mergers, and consolidations raised several arguments in favor of its passage: (1) the government should not tax individuals on a continuing investment in which no cash changes hands; (2) the government should not tax involuntary realization events such as a non-unanimously approved merger; (3) gain or loss on a reorganization was too difficult to value for purposes of taxation; and (4) the government should remove the tax burden on

53. S. REP. NO. 65-103, at 3 (1917), *reprinted in* 1939-1 C.B. (pt. 2), at 56, 57.

54. *See id.* at 23, *reprinted in* 1939-1 C.B. (pt. 2), at 70 tbl.C.

55. *See id.*

56. *See id.* at 23, *reprinted in* 1939-1 C.B. (pt. 2), at 69 tbl.B.

57. *See* Revenue Act of 1917, ch. 63, § 2, 40 Stat. 300, 301.

58. *See* WILLIAM A. KLEIN & JOSEPH BANKMAN, FEDERAL INCOME TAXATION 7 (11th ed. 1997); WEBBER & WILDAVSKY, *supra* note 38, at 442.

59. BLAKEY & BLAKEY, *supra* note 50, at 153.

60. PAUL, *supra* note 8, at 9; *see also* Posin, *supra* note 31, at 1341 ("Higher rates are the mother of tax invention, and it was the tax act of 1917, with unprecedently steep marginal rates designed to help finance World War I, that stimulated an interest in reorganization provisions.").

what were considered necessary business adjustments.

First, the public was uneasy with the concept of taxing a shareholder currently on gain from a continuing investment in which the taxpayer receives no cash from which to pay his taxes. In *Eisner v. Macomber*,[61] one of the earliest and most famous cases on the concept of income and realization, the Supreme Court recognized as highly probative in its decision favoring the taxpayer that a shareholder who received a stock dividend would have to engage in the additional realization transaction of selling shares in order to pay the tax.[62] Professor Roswell Magill related the story of a taxpayer who was informed that he had realized taxable gain on the exchange of his stock in General Motors of New Jersey for stock in General Motors of Delaware. According to Magill, the taxpayer "called the law an ass, since his capital was still subject to the risks of the automobile business, and nothing, in his view, had been severed from it and made available for expenditure for his private use and enjoyment."[63] Referring to the same transaction, Professor James Fahey noted that treating this transaction as taxable was not fundamentally "in accord with the business man's idea of realization"[64] in that "his bank account has not been swelled by funds which would enable to him to pay such a tax."[65] While a "substantive" transaction such as a sale for cash or a cash-equivalent justified the imposition of a tax on gains realized, the shareholder in a reorganization is in no "better position to pay than he is at the moment of a reorganization."[66] His investment in the business

61. 252 U.S. 189 (1920).

62. *See id.* at 213 ("Nothing could more clearly show that to tax a stock dividend is to tax a capital increase, and not income, than this demonstration that in the nature of things it requires conversion of capital in order to pay the tax.").

63. ROSWELL MAGILL, TAXABLE INCOME 123 (1936) (referring to the transaction in *Marr v. United States*, 268 U.S. 536 (1925), in which General Motors shifted its state of incorporation from New Jersey to Delaware). According to the American Law Institute's Subchapter C Project, "[i]t was undoubtedly part of the purpose of enacting the reorganization provisions to reverse the results in these cases." AMERICAN LAW INST., *supra* note 8, at 157.

64. James E. Fahey, *Income Tax Definition of "Reorganization,"* 39 COLUM. L. REV. 933, 934 (1939).

65. *See id.* at 934 n.6; *see also* ROBERT S. HOLZMAN, CORPORATE REORGANIZATIONS: THEIR FEDERAL TAX STATUS 68 (1948) ("[I]f an exchange is deemed taxable and yet the taxpayer has received nothing that is more than a paper profit, where is he going to get the money to pay the tax?"); Everett Skillman, Comment, *The Non-Recognition of Taxable Gain in Corporate Reorganizations—Reassessing Legislative Policy*, 20 SW. U. L. REV. 369, 373-74 (1991) (noting that courts deem "paper profits" arising from a reorganization as a nontaxable event).

66. PAUL, *supra* note 8, at 5-6; *see also* Saterlee, *supra* note 28, at 639 (considering "the statutory definitions of reorganizations as bearing upon intercorporate

continues in modified corporate form.[67] Some scholars expressed this "continuing transaction" rationale as a desire to define taxable income in terms of cash receipts.[68] Milton Sandberg noted that "[t]his concept . . . is based on readily apparent practical grounds. They are (1) that the cash concept comes close to laymen's ideas about income; (2) that it is conveniently administered; and (3) that since tax must be paid in cash, it is cash which best measures ability to pay."[69] According to Sandberg, the belief that the reorganization provisions followed this cash receipt concept "probably accounts for the most popular acceptance of the statutes as 'fair.' "[70]

Second, the public was even more reluctant to impose a tax on a shareholder in a continuing investment when the shareholder had no effective opportunity to participate in the decision to engage in the transaction. Taxing a shareholder who neither voted for nor desired the transaction upon which gain was recognized seemed inconsistent with the popular, although not the tax lawyer's, notion of realization.[71] Prior to the turn of the century, unanimous shareholder consent was the general rule for fundamental corporate changes such as mergers or consolidations.[72] In 1880, the Supreme Court held in

transactions").

67. *See* Ballantine, *supra* note 50, at 589.

68. *See, e.g.*, Robert H. Montgomery, *Reorganizations and the Closed Transaction, in* THE FEDERAL INCOME TAX 114, 121 (Robert M. Haig ed., 1921).

69. Milton Sandberg, *The Income Tax Subsidy to "Reorganizations,"* 38 COLUM. L. REV. 98, 100 (1938). Sandberg, however, criticized the applicability of the continuing transaction concept to the reorganization provisions since both property and cash were already taxed under the reorganization provisions and the rest of the Code did not adhere to a cash receipts standard. *See id.*

Tax policy theorists still mention the liquidity of the taxpayer, or her ability to pay a tax imposed, as one of the components of measuring the administrability of the tax. *See, e.g.*, William Blatt, *The American Dream in Legislation: The Role of Popular Symbols in Wealth Tax Policy*, 51 TAX L. REV. 287, 300 (1996).

70. Sandberg, *supra* note 69, at 100.

71. Homer Hendricks distinguished between technical "realization" and "actual realization" in noting that "until that paper profit or paper loss is actually realized, there is no logic or fairness in subjecting the transaction to tax or in permitting it to be used as a basis for a loss, in the absence of a clear direction on the part of Congress." Homer Hendricks, *Developments in the Taxation of Reorganizations*, 34 COLUM. L. REV. 1198, 1221 (1934). Commentators continue to express a general uneasiness with taxation of forced realization events. *See, e.g.*, Note, *Tax Consequences of Contract Breach: Proposed Relief for the Forced Realization of Income*, 11 VA. TAX REV. 915 (1992).

72. *See* HORWITZ, *supra* note 35, at 87; Taylor, *supra* note 40, at 701; Elliott J. Weiss, *The Law of Take Out Mergers: A Historical Perspective*, 56 N.Y.U. L. REV. 624, 627 (1981); Comment, *supra* note 40, at 112. There were several exceptions to this dominant common law rule. *See, e.g.*, 1849 Mass. Acts ch. 223, § 11 (majority approval required); Act of Feb. 15, 1831, § 1, 1831 N.J. Laws 124, 124 (seven-eighths approval required); Act of Mar. 24, 1856, ch. 197, § 3, 1856 Pa. Laws 169, 170 (two-thirds approval required).

Mason v. Pewabic Mining Co.[73] that shareholders in a corporation are no different than partners in a partnership in their right to unanimous consent prior to a sale of all of a dissolving corporation's assets and property.[74] Under this rule, a merger or consolidation could not occur without each individual shareholder's decision to enter into the transaction. By the turn of the century, however, this rule of shareholder unanimity showed signs of weakening.[75] When Congress adopted the provisions, the common law rule had been abrogated by statute in most states so as to permit fundamental corporate changes to go forward with the approval of as little as a simple majority of the corporation's shareholders.[76] Even though a technical realization event occurred upon the merger of two companies, the result resembled an involuntary conversion of a taxpayer's property through fire, storm, or eminent domain rather than a sale or exchange.[77] At the same time that the reorganization provisions were first adopted in 1918, the Treasury issued regulations providing nonrecognition treatment for any gain realized in such circumstances in acknowledgment of the involuntary nature of the realization event.[78] The involuntary aspects of a non-unanimously approved merger or consolidation suggested the equity of providing similar deferral of any amounts realized.

A third justification for not immediately recognizing the gains or losses incurred in reorganizations was the difficulty in valuing the

73. 133 U.S. 50 (1890).

74. *See id.* at 59.

75. One example of the weakening that was an exception to the rule for insolvent corporations was expanded to include the period prior to when a business actually lost all of its assets. *See* HORWITZ, *supra* note 35, at 88.

76. *See* Joseph L. Weiner, *Payment of Dissenting Stockholders*, 27 COLUM. L. REV. 547, 547 (1927); Comment, *supra* note 40, at 113.

77. *See* AMERICAN LAW INST., *supra* note 8, at 158 ("The point may be that corporate action to carry out a merger, for example, is effective without the individual consent or voluntary participation of each individual shareholder, and that there is something harsh about imposing a tax on appreciation realized in such a transaction."); ROBERT N. MILLER ET AL., REORGANIZATIONS AND OTHER EXCHANGES IN FEDERAL INCOME TAXATION 202-03 (1931) (describing the tax consequences of involuntary conversions). The ALI report goes on to criticize this rationale on the ground that many unilateral corporate actions result in individual tax consequences. *See* AMERICAN LAW INST., *supra* note 8, at 158. This argument, however, ignores the historical background of the shareholder unanimity requirement for mergers or consolidations.

78. Treasury Decision 2706 was promulgated on April 25, 1918, in response to wartime conditions. *See* T.D. 2706, 20 Treas. Dec. 348 (1918), *reprinted in* MILLER ET AL., *supra* note 77, at 203. As one treatise explained, "[f]or the Government to requisition a ship, for instance, and almost immediately to exact a surtax or excess profits tax of more than three-quarters of the gain, involved an injustice so apparent that a prompt remedy seemed necessary." *Id.* at 203 n.3.

stock of corporations, especially when the stock was not publicly traded.[79] Sometimes referred to as "the bogy man of taxation," valuation was frequently relied upon in arguments to Congress about the administrability of many kinds of taxes.[80] In testimony to the Senate Finance Committee on amending certain provisions of the 1918 Revenue Act, one advisor to the Treasury Department noted that one of the rationales for broadening the reorganization provisions was the difficulty in making appraisals: "In the average reorganization, or in many reorganizations, there is no definite, fixed market price for the securities."[81] Although this argument was roundly criticized by commentators because of the continued existence of the valuation problem for most kinds of reorganization boot,[82] it appealed to the general desire to remove complexity and to establish simplicity or administrability in the tax system. This concern about the complexity of the Code remains one of the fundamental precepts of tax policy analysis.[83]

The final rationale cited in support of nonrecognition treatment was the desire to remove any obstacles to necessary business adjustments. The reorganization provisions originally were not designed to stimulate mergers and consolidations, but rather to minimize any negative effect the uncertainty surrounding their tax treatment had on the decision to engage in such transactions. One of the original goals of the tax system was to remain as neutral or impartial as possible in its effect on an otherwise efficient economy.[84]

79. Valuation difficulties arose even in the context of publicly traded stock or securities. *See, e.g.*, Staley v. Commissioner, 41 B.T.A. 752, 775 (1940) (applying a large block discount in the context of valuation of a gift); Safe Deposit & Trust Co. v. Commissioner, 35 B.T.A. 259, 262-63 (1937) (applying a large block discount in the context of the valuation of an estate).

80. PAUL, *supra* note 8, at 6 n.13; *see also* Sandberg, *supra* note 69, at 100-01 (noting that despite the common argument that capital gains statutes "simplify administration by decreasing the need for valuation," these statutes have "actually *increased* the number of occasions for a valuation by introducing allocation formulae in which 'value' is one element").

81. *Hearings on H.R. 8245 Before the Senate Comm. on Fin.*, 67th Cong. 29 (1921) [hereinafter *Hearings on H.R. 8425*] (statement of Dr. T.S. Adams, advisor to the Treasury Department).

82. *See, e.g.*, PAUL, *supra* note 8, at 6; Sandberg, *supra* note 69, at 100-01. "Boot" refers to property that does not qualify for nonrecognition treatment—such as property not received in exchange for stock in the target corporation. The term apparently originated from the fact that the taxpayer receives nontaxable stock and other property "to boot." HOWARD E. ABRAMS & RICHARD L. DOERNBERG, FEDERAL CORPORATE TAXATION ¶ 2.06, at 26 n.23 (4th ed. 1998).

83. *See, e.g.*, JOHN F. WITTE, THE POLITICS AND DEVELOPMENT OF THE FEDERAL INCOME TAX 31 (1985); Blatt, *supra* note 69, at 300-01.

84. *See* KLEIN & BANKMAN, *supra* note 58, at 23. This goal continues to be cited by

Roswell Magill explained that since the income tax was not originally seen as an "instrument for social control, it was natural for Treasury to propose and Congress to adopt statutory provisions intended to eliminate the bars which the federal income tax, as interpreted by the Supreme Court, had placed across the road to normal corporate reorganizations."[85] As discussed previously, high wartime taxes discouraged corporations and their shareholders from entering into transactions that would otherwise be efficient and justified for the company and the economy. In the absence of a reorganization provision, one post-1918 commentator predicted that stock ownership "would tend to become fossilized" and the freedom to enter into necessary business combinations would be severely limited.[86] The commentator explained that "[i]f the Government as the keeper of the toll bridge exacts too great a toll, the bridge will simply not be crossed," even though "frequent crossings would be of convenience to the travelers and of incalculable benefit in encouraging commerce and industry, from which other revenue could be collected."[87] In the early years of the federal income tax, this result seemed contrary to the goals of the reorganization provisions.

Congress was apparently swayed by the arguments that such

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modern theorists. *See, e.g.*, Ernest S. Christian, *De-Radicalizing Tax Reform*, TAX NOTES TODAY, Apr. 13, 1998, at 70-81, *available in* LEXIS, Fedtax Library, TNT File ("The common goal of all the leading tax reform proposals is to be 'neutral.' "); Deborah Paul, *The Sources of Tax Complexity: How Much Simplicity Can Fundamental Tax Reform Achieve?*, 76 N.C. L. REV. 151, 195 (1997). Sheldon Pollack voices the traditional counterpoint that federal tax policy has always concerned itself with managing the national economy. *See* Sheldon D. Pollack, *The Failure of U.S. Tax Policy: Revenue and Politics*, 73 TAX NOTES 341, 341 (1996). This argument, however, is not necessarily inconsistent with the neutrality point. Much of the effort at management is merely an attempt to overcome the tax system's inefficient influences on the economy.

85. MAGILL, *supra* note 63, at 123-24; *see also* Hendricks, *supra* note 71, at 1209 ("Beginning with the Revenue Act of 1918, Congress has realized that there are certain types of business transactions involving the exchange of securities which ... represent normal business adjustments of a kind which ought not to be interfered with."). One commentator saw the reorganization provisions as evidence of government's active participation in cultivating business, rather than its effort to remain a neutral bystander:

> The reorganization and exchange provisions were passed to expedite consolidations and mergers, and the alteration of capital structure. The government, in its unique position as tax collector, is a major stockholder in every profit-making corporation; and it is definitely to the government's interest to see that reorganizations are effected if such reorganization will enable the corporation to effect operating economies or other legitimate undertakings that will produce higher net incomes—and hence higher tax revenues for the Bureau of Internal Revenue.

HOLZMAN, *supra* note 65, at 68.

86. Hendricks, *supra* note 71, at 1222.

87. *Id.*

reorganizations produced no meaningful change in participation in the continuing business venture and that imposition of a tax on them would discourage "necessary business adjustments."[88] In section 202(b) of the 1918 Act, Congress exempted certain transactions from the general realization requirement in exchanges of property:

> When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.[89]

When the aggregate par or face value of the stock or securities received exceeded that of the stock or securities exchanged, gain was recognized in the amount of the excess.[90]

Although observers welcomed the concept of nonrecognition treatment for mergers and consolidations, several parties quickly levied complaints against the reach and scope of the 1918 Act's reorganization exemption. Essentially, these complaints addressed the following issues: (1) the failure to define the transactions to which the nonrecognition treatment applied; (2) the decision to impose an ill-conceived equivalent par value requirement for exchanged shares of stock; and (3) the narrow application of the provision to stock-for-stock exchanges between different corporations.

First, the statutory provision did not clear up the uncertainty surrounding the tax treatment of these transactions because it did not attempt to define the terms "reorganization, merger, or consolidation," and no regulations or other interpretive guidance accompanied the Act. Although the concepts of merger and consolidation were reasonably well developed under the common law, courts and state legislatures often blurred their meanings, either by design or through inattention to detail.[91] Generally, "merger" is

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88. Sandberg, *supra* note 69, at 99.

89. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1058, 1058 (1919).

90. *See id.*

91. *See* RANDOLPH E. PAUL, SELECTED STUDIES IN FEDERAL TAXATION: SECOND SERIES 7 n.11 (1938); *see also* Bisbee, *supra* note 40, at 406 ("Indeed, taking the legislative

used to describe a process by which one corporation is completely absorbed by another corporation that continues in existence and operates the combined enterprise,[92] while "consolidation" is used to describe the uniting of two corporations into a completely new one.[93] In practice, however, many variations on these concepts were permitted, some of which had little connection to the type of transaction contemplated in the reorganization exemption. For instance, because of states' reluctance to give up authority over corporations operating within their jurisdiction and their inability under mid-nineteenth century law to exercise authority over corporations acting outside of their jurisdiction, a consolidation involving corporations of two different states was held not to result in the dissolution or merging out of existence of either constituent corporation.[94] Additionally, courts frequently referred to a transaction that was in form a sale of assets as a merger.[95] In *United States v. Republic Steel Corp.*,[96] the court characterized a sale of assets for stock followed by a dissolution of the selling corporation and the distribution of the acquirer's shares to its stockholders as a merger.[97] Moreover, even if the concepts of merger or consolidation could be sorted out, "reorganization" was itself vague and ill-defined. In one contemporary treatise, the term was defined as " 'the act or process of organizing again or anew. In the law of corporations, it means only what the term itself indicates, that a corporation has by some process organized anew; and yet it implies that some of the features of the old corporation are retained.' "[98] This definition left practitioners wondering which features of the old corporation could

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enactments of New York, New Jersey, Delaware and those of the Federal Government dealing with national banks as examples, only New York uses the words aptly.").

92. *See* WALTER CHADWICK NOYES, A TREATISE ON THE LAW OF INTERCORPORATE RELATIONS § 11, at 15 (1902); PAUL, *supra* note 91, at 7 n.11. Of course, in the non-legal environment, the term "merger" is much more broadly defined to include the purchase of assets and the creation of a holding company. *See* Lackman, *supra* note 46, at 551.

93. *See* Collinsville Nat'l Bank v. Esau, 176 P. 514, 516 (Okla. 1918); PAUL, *supra* note 91, at 7 n.11.

94. *See* NOYES, *supra* note 92, § 102 at 161 (citing Racine R.R. Co. v. Farmers' Loan & Trust Co., 49 Ill. 331, 348 (1868) (noting that "[w]hile [a consolidation of an Illinois and Wisconsin corporation] created a community of stock and of interest between the two companies, it did not convert them into one company, in the same way, and to the same degree, that might follow a consolidation of two companies within the same State")).

95. *See* Comment, *supra* note 40, at 107.

96. 11 F. Supp. 117 (N.D. Ohio 1935).

97. *See id.* at 120.

98. Fahey, *supra* note 64, at 937 n.16 (quoting 8 THOMPSON ON CORPORATIONS § 5960 (3d ed. 1927)).

be retained and which needed to be scrapped in the reorganizing process. Such uncertainty meant that the provision failed to alleviate taxpayers' concerns over the taxability of their transactions.

A second complaint levied against the reorganization exemption was that it only applied to exchanges of stock or securities of equal aggregate par or face value—an indicia of dubious worth. During the nineteenth century, par value, which represents the amount fully paid in to capital from the sale of stock or securities, was one of the few kernels of information publicly available on a business corporation.[99] The concept appears to have originated in the custom of stating on the stock certificate the amount contributed by the holder to the corporation.[100] Lay investors and creditors were led to believe that the corporation, through the issuance of its shares of stock, held cash and property in an amount equal to the aggregate par value of the shares.[101] This was often not true, though, because the capital stock of many corporations was literally flooded with "watered" stock.[102] In many cases, state corporation laws either did not require full payment for a company's shares or provided no penalty for the failure to adhere to such a requirement.[103] Furthermore, early attempts to require all subscriptions to be made in cash, most notably by New York in 1848, were soon abandoned in favor of provisions permitting payment in the form of labor or property—consideration that easily could be overvalued.[104] As early as 1892, a report was issued by a special committee of the New York Bar Association recommending a form of no-par stock which would, according to the report, "relieve any possibility of injury to the public from misleading representations as to the money value of corporate stock."[105] The recommendations fell on deaf ears at the time, but were revived two decades later in 1912 when New York passed the first law in America permitting the issuance of no-par stock.[106] Although only five states

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99. *See* BASKIN & MIRANTI, *supra* note 33, at 179.

100. *See* JOHN R. WILDMAN & WELDON POWELL, CAPITAL STOCK WITHOUT PAR VALUE 20 (1928).

101. *See* NORMAN D. LATTIN, THE LAW OF CORPORATIONS 469 (2d ed. 1971). Courts reinforced this belief. *See* Scovill v. Thayer, 105 U.S. 143, 153 (1881) (stating that a creditor could enforce payment of the balance of the unpaid par value against the individual shareholders).

102. Watered stock is stock issued at a discount from par value or distributed as a bonus to promoters without collecting any cash. *See* LATTIN, *supra* note 101, at 472.

103. *See id.* at 469-70.

104. *See* LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 514-15 (1985); WILDMAN & POWELL, *supra* note 100, at 21.

105. WILDMAN & POWELL, *supra* note 100, at 23-24.

106. *See id.* at 25-27. The concept of no par stock had its origin in Germany, where it

had followed New York's lead by the time the first reorganization provision was adopted in 1918, seventeen more states adopted such provisions between 1918 and 1921.[107] Louis Marshall noted in 1919 that " '[i]t has now become the usual thing for corporations which are honestly managed to issue their stock without par value.' "[108] For two companies to have stock of the same or similar par value would require an arbitrary and formalistic coincidence unrelated to the aim of the reorganization provisions to exempt exchanges of stock having equivalent value.[109] In *Eisner v. Macomber*,[110] the Supreme Court officially recognized the irrelevance of par value when it held that a stock dividend was merely an increase in the number of shares with a concomitant decrease in the value of each share, despite the fact that the newly distributed stock held the same $100 par value as the original shares.[111] Thus, it was clear almost immediately after passage of the 1918 Act's reorganization exemption that its reliance on an anachronistic feature of state corporate law made it arbitrary and unusable.[112]

A final critique of the reorganization exemption was that it was limited to stock-for-stock exchanges among different corporations even though many other transactions seemed to fall under the popular conception of a reorganization. In the Secretary of the Treasury's Notes on the Revenue Act of 1918, he acknowledged this criticism, writing that "[i]t has been suggested that there are other similar transactions in which it is difficult to determine the gain or loss in the absence of an actual sale and which should be treated in

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was permitted in mining corporations as early as 1865. *See id.* at 22-23.

107. *See* BASKIN & MIRANTI, *supra* note 33, at 180 n.21; WILDMAN & POWELL, *supra* note 100, at 27-28.

108. WILDMAN & POWELL, *supra* note 100, at 29 (quoting Louis Marshall, *in* Frederick H. Hurdman, *Capital Stock of No Par Value*, 28 J. ACCT. 246, 247 (1919)).

109. *See* PAUL, *supra* note 8, at 18.

110. 252 U.S. 189 (1920).

111. *See id.* at 211; BASKIN & MIRANTI, *supra* note 33, at 182; MAGILL, *supra* note 63, at 31.

112. *See* Posin, *supra* note 31, at 1348; Sandberg, *supra* note 69, at 102 ("The 1918 statute was of little aid to taxpayers because of the curious stress it placed on par values. It was also probably unconstitutional in so far as it may have been construed to tax increased par values in reorganizations involving no constitutionally realized income.").

Although clear to commentators, the failings of the par value standard were not so obvious to members of Congress. One senator, convinced that par value was the only measure of equivalent value in a merger or consolidation, argued during the debates over the Revenue Act of 1921 that the removal of the requirement that the shares in a reorganization be of equal par value "ought to be designated a law for the purpose of pumping water into securities, for that is what it amounts to." 61 CONG. REC. 6562 (1921) (statement of Sen. Jones).

the same manner in connection with the reorganization, merger, or consolidation of a corporation."[113] Experience had demonstrated that business transactions covered a much broader spectrum than envisioned under the 1918 Act. A series of cases arose under pre-1918 Revenue Acts, each eventually ending up at the Supreme Court, in which the Commissioner of Internal Revenue asserted that relatively minor exchanges and reorganizations of single enterprises constituted taxable events.[114] In *United States v. Phellis*,[115] for example, the E.I. du Pont de Nemours Powder Company, a New Jersey corporation, transferred all of its assets to a new Delaware company created with a higher capitalization in exchange for the stock of the new corporation.[116] The New Jersey corporation then distributed the shares in the Delaware corporation to its stockholders as a dividend.[117] The Commissioner asserted that income was realized to the extent of the market value in the new shares.[118] While the Court of Claims held for the taxpayer,[119] the Supreme Court reversed in 1921. According to the Court, the fact that the new corporation was organized under the laws of a different state distinguished the transaction from a mere reorganization of the same corporation.[120] In a similar case, *Rockefeller v. United States*,[121] however, a portion of assets was transferred to a new corporation in the same state, and the Court held that the transaction was taxable

113. SECRETARY OF THE TREASURY, 65TH CONG., 3D SESS., NOTES ON THE REVENUE ACT OF 1918: SUBMITTED BY THE SECRETARY OF THE TREASURY, WITHOUT RECOMMENDATION AT THIS TIME 7-8 (Comm. Print 1919) [hereinafter NOTES ON THE REVENUE ACT OF 1918], *reprinted in* 94 U.S. REVENUE ACTS, *supra* note 31.

114. *See, e.g.*, Marr v. United States, 268 U.S. 536, 541-41 (1925) (holding that reincorporation was taxable); Cullinan v. Walker, 262 U.S. 134, 137-38 (1923) (holding that stock of an operating company exchanged for stock in a holding company that controlled two corporations controlling all of the operating company's previously undivided assets was taxable); Rockefeller v. United States, 257 U.S. 176, 183-84 (1921) (holding that spin-off of a portion of the assets of one corporation to a corporation controlled by its stockholders was taxable); United States v. Phellis, 257 U.S. 156, 175 (1921) (holding that reincorporation of a corporation in another state was taxable). In *Weiss v. Stearn*, 265 U.S. 242 (1924), the Court held that a transaction was not taxable where the stockholders received stock in a new corporation in the same state with no differences except the infusion of cash from a lending institution. *See id.* at 252.

115. 257 U.S. 156 (1921).

116. *See id.* at 165-67.

117. *See id.* at 166-67.

118. *See id.* at 168.

119. Phellis v. United States, 56 Ct. Cl. 157, 176 (1921).

120. *See Phellis*, 257 U.S. at 175. Today, this transaction might be effected as an "F" reorganization involving "a mere change in identity, form, or place of organization of one corporation, however effected." I.R.C. § 368(a)(1)(F) (West Supp. 1998).

121. 257 U.S. 176 (1921).

because the stockholders became owners of two separate corporations.[122] In both cases, no exchange of shares took place, and neither transaction would have obtained relief through the application of the 1918 Act's reorganization exemption. Given these and other real world examples to which the reorganization exemption apparently offered little relief, observers sought to increase dramatically the scope of the reorganization exemption from the paradigm stock-for-stock transaction. According to the Secretary,

> [t]he following four classes of transactions have been urged as proper additional exceptions to the general rule laid down in section 202(b):
>
> 1. When the market value of the property received can not be satisfactorily determined.
>
> 2. When property is exchanged in return for all or substantially all of the stock of a corporation.
>
> 3. When property is exchanged between corporations affiliated within the meaning of section 240.
>
> 4. When, in connection with the reorganization of a corporation or partnership, one corporation or partnership exchanges property with another corporation or partnership involved in such reorganization, or a person receives in place of stock or securities owned by him, new stock or securities.[123]

These four proposed transactions were notable not only for their expansion of the exemption from stock transactions to stock-for-property transactions, but also for their inclusion of partnership transactions.

The Bureau of Internal Revenue attempted to address some of the criticisms of the Act through the issuance of regulations. A 1919 version of Regulation 45 promulgated under the 1918 Act had not addressed the reorganization issue, but the Bureau amended the regulation on January 28, 1921, to define the term "reorganization" to include the following transactions:

> (*a*) the dissolution of corporation B and the sale of its assets to corporation A, or (*b*) the sale of its property by B to A and the dissolution of B, or (*c*) the sale of the stock of B to A and the dissolution of B, or (*d*) the merger of B into A, or

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122. *See id.* at 183. Today, this transaction might have been effected as a "D" reorganization in which one corporation spins off assets to a corporation controlled by its shareholders in a transaction that qualifies under § 355. *See* I.R.C. § 368(a)(1)(D).

123. NOTES ON THE REVENUE ACT OF 1918, *supra* note 113, at 8.

(*e*) the consolidation of the corporations.[124]

Although the regulation did not define "merger" or "consolidation," it did define "reorganization" and it broadened the scope of the exemption to other transactions such as "cases of corporate readjustment where stockholders exchange their stock for the stock of a holding corporation" in which the two corporations are closely related.[125] Regulation 45 also addressed the issue of no-par stock, permitting the amount under local law that a corporation with no-par stock is required to keep in capital and not impair by the distribution of dividends to be treated as the aggregate par value of the corporation's shares.[126] Where no such capital was required to be kept unimpaired, the Regulations conceded that such stock would in fact have "no greater aggregate par or face value than the stock or securities exchanged therefor."[127] Despite the clarifications provided by Regulation 45, it did not go far enough to improve the workability of the reorganization provision. As Homer Hendricks noted, "[t]he 1918 provisions were impracticable in operation; the then status of the law was such as to hamper necessary business adjustments."[128]

2. 1921-1934

By 1921, the reorganization exemption's de facto presumption in favor of taxation appeared particularly out of step with the efforts to jump-start the nation's economy through tax reform prior to the "roaring twenties."[129] The 1918 Act's attempt to reduce the tax-driven obstacles to business reorganizations had failed to achieve its objective. In testimony before the Senate Finance Committee in September of 1921, Dr. T.S. Adams, an economic advisor to the Treasury Department,[130] argued that "the principal defect of the

124. Treas. Reg. 45, art. 1567 (Jan. 28, 1921), *reprinted in* 134 U.S. REVENUE ACTS, *supra* note 31; *see also* PAUL, *supra* note 8, at 20 (quoting Treas. Reg. 45, art. 1567).

125. Treas. Reg. 45, art. 1567, *reprinted in* 134 U.S. REVENUE ACTS, *supra* note 31.

126. *See id.*

127. *Id.*

128. Hendricks, *supra* note 28, at 648 n.1.

129. During the campaign leading up to the 1920 elections, Republicans declared that "one of the chief needs of the country is the revision of taxation as one way to lower the cost of living, restore business confidence, and stimulate business enterprise." BLAKEY & BLAKEY, *supra* note 50, at 190. One of the principal targets for reform was the excess profits tax. *See id.* at 191.

130. Adams has been called the "father of the 1921 Act." Ronald H. Jensen, *Of Form and Substance: Tax-Free Incorporations and Other Transactions Under Section 351*, 11 VA. TAX REV. 349, 383 n.117 (1991). During the period in question, Adams, a professor of political economy at Yale, was the principal Treasury spokesperson before the Senate Finance Committee and the House Ways and Means Committee on tax legislation and was

present law is in blocking desirable business readjustments."[131] While there were other justifications for amending the reorganization exemption, Dr. Adams reported that "the most important reason [was that] [a]ll kinds of business readjustments have been stopped" because of the threat of heavy taxation.[132]

Economic and business necessity were persuasive rationales for tax reform in 1921. The end of World War I had led to a drop in the artificially high prices that had dominated during the previous few years, and the country found itself in the midst of an economic downturn in 1920.[133] Approximately 20,000 companies went out of business during 1921, and 4,750,000 persons were unemployed.[134] According to a House Ways and Means Committee Report submitted in August of 1921, "the exacting of the present excessive sums of taxes from the country contributes in no small degree to the depressing influences under which business and industry in general are staggering as an aftermath of the World War."[135] The Committee explained that the financial ravages of war are felt most acutely "after the cessation of hostilities, at which time the demand for war supplies terminates, with a resulting shrinkage of values. The Nation is now passing through the trying period of liquidation and readjustment. The reduction of the tax burdens is essential to business recovery."[136]

Congress concluded that one component of the effort to reduce the tax burden on business was to amend the reorganization exemption to broaden its scope and to clarify its uncertainties.[137] Under the Revenue Act of 1921, the reorganization exemption no

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considered one of the foremost tax and public finance theorists of his day. *See* Michael J. Graetz & Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 DUKE L.J. 1021, 1029-30 (1997).

131. *Hearings on H.R. 8245*, *supra* note 81, at 29 (statement of Dr. T.S. Adams, advisor to the Treasury Department).

132. *Id.* This sentiment was echoed on the floors of Congress. In debates over the removal of the par value requirement, one senator noted that "when so much reorganization is going on in the business world, it is thought by all those interested in the upbuilding of the industries of the country at this time that this is a very helpful provision." 61 CONG. REC. 6563 (1921) (statement of Sen. Watson).

133. *See* 1 CHARLES A. BEARD & MARY R. BEARD, AMERICA IN MIDPASSAGE 28 (1939); PAUL, *supra* note 8, at 21; Jensen, *supra* note 130, at 386 n.126.

134. *See* Jensen, *supra* note 130, at 386 n.126.

135. H.R. REP. NO. 67-350, at 1 (1921), *reprinted in* 1939-1 C.B. (pt. 2), at 168.

136. *Id.*

137. *See* ROSWELL MAGILL, THE IMPACT OF FEDERAL TAXES 130 (1943) ("[I]n the early twenties, Congress regarded business reorganizations as frequently desirable and often necessary. Hence, successive revenue laws contained increasingly liberal provisions.").

longer depended on the par value of the stock involved in the exchange and included a definition of "reorganization" that was designed to address some of the previous concerns. Section 202(c)(2) provided for nonrecognition of gain or loss

> [w]hen in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected) . . . .[138]

In discussing this amended provision, the House Ways and Means Committee explained that "[p]robably no part of the present income-tax law has been productive of so much uncertainty and litigation or has more seriously interfered with those business readjustments which are peculiarly necessary under existing conditions."[139] Moreover, one byproduct of the economic downturn was that parties were using reorganizations to recognize losses. The Committee noted that the provision, "if adopted, will, by removing a source of grave uncertainty, not only permit business to go forward with the readjustments required by existing conditions but will also considerably increase the revenue by preventing taxpayers from taking colorable losses in wash sales and other fictitious exchanges."[140]

Congress further liberalized the reorganization exemption in the Revenue Act of 1924, a monument to comprehensiveness and detail, under the guidance of A.W. Gregg, Special Assistant to the Secretary of the Treasury.[141] First, the 1924 Act expanded the definition of reorganization to include spin-offs and split-offs.[142] Representative

138. Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 227, 230.

139. H.R. REP. NO. 67-350, at 10, *reprinted in* 1939-1 C.B. (pt. 2), at 175. The Senate Finance Committee issued an almost identical statement. *See* S. REP. NO. 67-275, at 11 (1921) ("Probably no part of the present income tax law has been productive of so much uncertainty or has more seriously interfered with necessary business readjustments."), *reprinted in* 1939-1 C.B. (pt. 2), at 188.

140. H.R. REP. NO. 67-350, at 10, *reprinted in* 1939-1 C.B. (pt. 2), at 176.

141. *See* Posin, *supra* note 31, at 1350.

142. *See* Revenue Act of 1924, ch. 234, § 203(h)(1), 43 Stat. 253, 257 (stating that the

Green of the House Ways and Means Committee explained to Congress that this amendment was inserted "to include other usual forms of corporate reorganization in the advance of business, such as the splitting of one corporation into two or more corporations, which I may say under the present law would not be permitted except by forming two entirely new corporations."[143] Second, the 1924 Act also formally extended the exemption from taxation to corporations so that they received the benefit of nonrecognition of any gain.[144] Although a Treasury interpretation had concluded that corporations were exempt under the 1921 Act, the Senate Finance Committee explained that "[t]he present ruling of the Treasury Department on this question is of doubtful legality and a statutory provision is most necessary."[145] This expansion was designed to further remove any limits placed on business readjustments by the tax law. The House Ways and Means Committee explained that nonrecognition treatment was granted in order to permit "ordinary business transactions" to go forward free from tax constraints, and "[i]f it is necessary for this reason to exempt from tax the gain realized by the stockholders, it is even more necessary to exempt from tax the gain realized by the corporation."[146] Finally, and perhaps most importantly, the 1924 Act refined the definition of reorganization to make it the exclusive definition for tax purposes.[147] This refinement

term "reorganization means ... (B) a transfer by a corporation of all or part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred"). A "spin-off" involves a contribution by a corporation of some or all of its assets to another corporation, followed by a distribution of the stock of that corporation to all of the first corporation's existing shareholders as a dividend. *See* 1 GINSBURG & LEVIN, *supra* note 7, § 1001. A "split-off" is the same transaction as a spin-off except that instead of distributing the new corporation's stock as a dividend, the stock is distributed to certain of the first corporation's shareholders in exchange for their stock in the original corporation. *See* 1 *id.* The result is two separate corporations with two separate groups of shareholders. *See* 1 *id.*

143. 65 CONG. REC. 2429 (1924), *reprinted in* J.S. SEIDMAN, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 697 (1938).

144. *See* Revenue Act of 1924, ch. 234, § 203(b)(3), 43 Stat. at 256 ("No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of a plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.").

145. S. REP. NO. 68-398, at 14 (1924), *reprinted in* 1939-1 C.B. (pt. 2), at 276; *see also* 11 MERTENS, *supra* note 29, § 43.02 (noting that the Mellon Bill codified the Treasury's decision to extend the benefits of nonrecognition to corporations and stockholders); Sandberg, *supra* note 69, at 102-03 (same). A regulation promulgated under the 1921 Act had construed the reorganization provisions so as to exempt corporations as well as their shareholders. *See id.* (citing Treas. Reg. 62, art. 1566(b) (1923)).

146. H.R. REP. NO. 68-179, at 13 (1924), *reprinted in* 1939-1 C.B. (pt. 2), at 250.

147. The 1924 Act replaced the phrase "the word 'reorganization' includes," with the

lessened the possibility that taxpayers would rely on general corporate law as their authority for reorganization status and thus, at least temporarily, elevated tax law above state corporate law for determining the taxable status of a reorganization.[148]

Despite the great improvements made by the 1921 and 1924 Acts in extending nonrecognition treatment to the typical business reorganization, the Acts went too far in at least one respect. The parenthetical clause in section 202(c)(2) of the 1921 Act, which permitted an acquisition of a majority of a corporation's voting stock or substantially all of its properties to qualify as a tax-free reorganization,[149] did not stipulate the consideration required for such an exchange. Thus, under the terms of the statute, a cash sale of a corporation's stock or assets could conceivably be classified as a reorganization—a possibility never contemplated by the drafters of the original reorganization exemption.[150] This "blunder of draftsmanship" led to confusion not over the treatment of cash consideration, since other provisions limited the tax benefits of nonrecognition and carryover basis to exchanges of stock or securities, but rather over the treatment of short-term notes and other forms of non-equity securities.[151] In the congressional debates over this section, the House held significant discussion over the type of property transferred to the acquiring corporation in a reorganization, but directed little attention to the type of consideration required.[152] According to one commentator, the unarticulated assumption was that any consideration would likely be paid in stock.[153] This assumption was not unreasonable in 1921. While bonds may have been the dominant class of securities issued during the nineteenth century, capital-raising techniques had evolved

phrase "the term 'reorganization' means." Revenue Act of 1924, ch. 234, § 203(h)(1), 43 Stat. at 257.

148. *See* Shores, *supra* note 27, at 442.

149. *See supra* text accompanying note 138.

150. *See, e.g.*, Brookes, *supra* note 9, at 5-6; Sandberg, *supra* note 69, at 105. A.W. Gregg, then-special assistant to the Secretary of the Treasury, issued a statement on the 1924 Act in which, among other things, he reported that the ability to gain nonrecognition treatment in a sale of property for cash in the context of a contribution to a controlled corporation " 'does not represent the intent of Congress, which was to exempt the gain only if the consideration consisted of stock or securities, with the result that it constituted a mere change in the form of ownership of the property.' " MILLER ET AL., *supra* note 77, at 397 (quoting from the Gregg Statement).

151. Brookes, *supra* note 9, at 5-6.

152. *See* 61 CONG. REC. 6549-50, 6561-69 (1921).

153. *See* Faber, *supra* note 7, at 241-42.

significantly at the beginning of the twentieth century.[154] As discussed earlier, common stocks had become the preferred method of investing by the 1920s.[155] Corporate finance was a nimble field, however, and investment bankers soon devised short-term debt instruments to take advantage of the reorganization exemption's seeming invitation to treat sales as tax-free reorganizations.[156] The parenthetical clause served as a significant source of confusion during the more than ten years it remained part of the reorganization provisions.[157]

In an attempt to limit this gaping hole in the statute, the Treasury Department took the position that the parenthetical clause was modified by the terms "merger or consolidation," and, therefore, any transaction described by the clause must resemble a merger or consolidation.[158] Because those terms were not uniformly defined, however, it was not immediately clear to what extent transactions described by the parenthetical clause were thus limited. One possible implication was that the transferring corporations must be dissolved, as a merged or consolidated corporation might be under the common law definitions.[159] The Court, however, rejected this argument, even though the argument received some support at the Bureau of Internal Revenue and before the Board of Tax Appeals.[160] Ultimately, the Court upheld the Treasury Department's interpretation by applying the somewhat looser requirements that the shareholders of the target corporation retain a continuity of proprietary interest in the venture and that the acquiring corporation continue the target's business in its modified corporate form.[161] These requirements were "based on the traditional conception of a merger or consolidation as a union of corporate assets into one

154. *See* BASKIN & MIRANTI, *supra* note 33, at 160, 167.

155. *See supra* notes 35-39 and accompanying text.

156. *See* Brookes, *supra* note 9, at 6 ("[I]n due course sales occurred by corporations of substantially all their assets to other corporations for the short-term notes of the latter, and the question was raised whether the gain was entitled to non-recognition under the tax statutes."); Comment, *Corporate Reorganization to Avoid Payment of Income Tax*, 45 YALE L.J. 134, 134 (1935).

157. *See* Sandberg, *supra* note 69, at 104-05.

158. *See id.* at 106.

159. *See id.*

160. *See* ROBERT H. MONTGOMERY, FEDERAL TAX HANDBOOK 168 (1935); Sandberg, *supra* note 69, at 106; *see also* G. & K. Mfg. Co. v. Helvering, 296 U.S. 389, 391 (1935) (holding that dissolution is not required to receive nonrecognition treatment); Helvering v. Minnesota Tea Co., 296 U.S. 378, 386 (1935) (same); John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935) (same).

161. *See, e.g.*, Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933).

organism, the owners of each of the old corporations becoming together the owners of the new."[162]

The requirement that a reorganization be characterized by both continuity of shareholder interest and continuity of business enterprise was first imposed by Circuit Judge Augustus Hand in *Cortland Specialty Co. v. Commissioner*.[163] In this case, the Cortland Company entered into an agreement with the Deyo Company in 1925 whereby the Cortland Company transferred substantially all of its assets to the Deyo Company in exchange for $53,070 in cash and $159,750 in six unsecured, short-term promissory notes payable at specified intervals over the next fourteen months.[164] The Cortland Company liquidated soon after the completion of the transaction and distributed the proceeds and all remaining assets to its two sole stockholders.[165] The issue presented was whether the transaction constituted a taxable sale or a tax-free reorganization.[166] The court noted that the agreement contemplated a sale in which Cortland's shareholders would sever their interest in the business.[167] The only way the transfer could be characterized as a reorganization was if the parenthetical clause permitted any transfer of "substantially all the properties" of one corporation to another to be a reorganization regardless of the consideration received in return.[168] The court determined, after a review of the statutory and common law definitions of the terms "merger" and "consolidation," that a mere sale was not sufficient to fall within the statutory exemption.[169] Although state statutes differed as to whether dissolution was required, the court concluded that "the general purpose of them all has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form."[170] Thus, "there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate form."[171] Since the short-term promissory

162. Sandberg, *supra* note 69, at 108.

163. 60 F.2d 937 (2d Cir. 1932).

164. *See id.* at 938.

165. *See id.* According to the court's estimates, 91.5% of Cortland's assets were transferred and only 8.5% were retained. *See id.*

166. *See id.* at 937.

167. *See id.* at 939.

168. *Id.*

169. *See id.* at 939-40.

170. *Id.* at 939.

171. *Id.* at 940.

notes were insufficient to demonstrate such continuity of interest or business, the court deemed the transaction a taxable sale.[172]

These judicially imposed requirements were soon adopted by the U.S. Supreme Court in *Pinellas Ice & Cold Storage Co. v. Commissioner*.[173] In this case, two commonly owned companies, Pinellas Ice & Cold Storage Company and Citizens' Ice & Storage Company, entered into an agreement in 1926 for the sale of substantially all of their assets to the National Public Service Corporation.[174] Of the $1.4 million purchase price, $400,000 was to be paid in cash with the balance to be represented by three secured promissory notes earning interest at 6%, each payable at specified intervals within the next six months.[175] Following the transfer, the cash and notes were distributed to the stockholders and the target corporations were dissolved.[176] The Court rejected the taxpayer's contention that this was a tax-free reorganization, holding that "to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."[177]

An additional protection was introduced by the Second Circuit in 1934 and approved by the Supreme Court a year later in the form of a business purpose requirement. In *Helvering v. Gregory*,[178] Mrs. Gregory, the sole stockholder of a holding company, the United Mortgage Company, desired to sell the holding company's stock in a subsidiary, the Monitor Securities Corporation, at a significant profit.[179] If the holding company sold the shares and then distributed the proceeds to Mrs. Gregory, however, both the holding company and Mrs. Gregory would have had to pay tax on the gain on sale. To avoid this result, Mrs. Gregory formed a new corporation ("Averill"), caused United Mortgage Company to transfer the Monitor Securities stock to Averill in a reorganization, and then liquidated Averill to receive the Monitor Securities stock.[180] Because of Mrs. Gregory's ability to allocate a portion of her basis in the United Mortgage stock to the Averill stock, she was able to deduct a larger basis from the securities received upon liquidation and thus reduce her capital gains

172. *See id.*
173. 287 U.S. 462 (1933).
174. *See id.* at 463-64.
175. *See id.* at 464.
176. *See id.* at 465.
177. *Id.* at 470.
178. 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).
179. *See id.* at 810.
180. *See id.*

taxes upon sale.[181] Judge Learned Hand, writing for the court, reversed the decision of the Board of Tax Appeals[182] that the transaction was immune from taxation under the literal terms of the statute. According to Judge Hand, given the original intent to aid necessary business adjustments, "the underlying presupposition is plain that the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious to its prosecution. To dodge the shareholders' taxes is not one of the transactions contemplated as corporate 'reorganizations.' "[183] The Supreme Court, in upholding the lower court's decision, appeared to distinguish between a prohibition on tax avoidance motives and a requirement of a business motive—approving only the latter.[184] According to the Court, the statutory language permitting a tax-free transfer of assets "means a transfer made 'in pursuance of a plan of reorganization' of corporate business; and not a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here."[185] As one observer complained in colorful fashion, the "business purpose" requirement, if applied as a test of subjective intent, "[was] all embracing, like a London fog."[186] The firestorm started by the *Gregory* Court's broad requirement of a business motive separate from a plan to reduce business taxes was, however, as much a function of the tax bar's growing reliance on tax avoidance techniques as on the questionable basis for the doctrine itself.[187]

Notwithstanding the development of such judicial protections, the abuse of the parenthetical clause's shoddy draftsmanship by taxpayers seeking to characterize sales as tax-free reorganizations led many to question whether a reorganization exemption was appropriate at all. According to the Treasury Department, because of the 1924 Act's attempt to legislate the minute details of the reorganization exemption, "astute lawyers could and did arrange

181. *See* Fahey, *supra* note 64, at 938; Sandberg, *supra* note 69, at 111.

182. *See* Gregory v. Commissioner, 27 B.T.A. 223 (1933), *rev'd sub nom.*, Helvering v. Gregory, 69 F.2d 809 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935).

183. *Gregory*, 69 F.2d at 811.

184. *See* Gregory v. Helvering, 293 U.S. 465, 469 (1935); *see also* Sandberg, *supra* note 69, at 112 (arguing that as long as a business motive exists, a tax avoidance motive is irrelevant).

185. *Gregory*, 293 U.S. at 469 (quoting Revenue Act of 1928, ch. 852, § 112(g), 45 Stat. 791, 818).

186. Satterlee, *supra* note 28, at 689.

187. *See, e.g.*, PAUL, *supra* note 8, at 125-26; Comment, *supra* note 156, at 140.

what were really sales to take the technical form of a reorganization within the statutory definition, with resultant loss of revenue."[188] Faced with such problems, a House Ways and Means Subcommittee conducted a study on tax avoidance and recommended that the reorganization and exchange provisions be abolished so as to simplify the revenue provisions and "close the door to one of the most prevalent methods of tax avoidance."[189] According to the Subcommittee, the abuses outweighed the advantages of retaining nonrecognition treatment.[190] The Subcommittee estimated that such a move would result in an increase in tax revenues of at least $18 million annually.[191]

Despite agreeing with the Subcommittee's basic premise, Treasury advised against the abolition of the reorganization exemption.[192] One seemingly plausible argument for retaining the exemption was that the economic climate had changed since 1921

188. STATEMENT OF THE ACTING SECRETARY OF THE TREASURY REGARDING THE PRELIMINARY REPORT OF A SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS RELATIVE TO METHODS OF PREVENTING THE AVOIDANCE AND EVASION OF THE INTERNAL REVENUE LAWS TOGETHER WITH SUGGESTIONS FOR THE SIMPLIFICATION AND IMPROVEMENT THEREOF, 73D CONG., 2D SESS. 9 (Comm. Print 1933) [hereinafter STATEMENT OF THE ACTING SECRETARY OF THE TREASURY], *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 31.

189. SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 8 (Comm. Print 1933), *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 31; *see also* PAUL, *supra* note 8, at 37 (stating that the committee recommendation was in the interest of the "twin phantoms" of tax simplification and the prevention of tax avoidance). In cases of hardship, the Subcommittee proposed permitting the postponement of payment rather than the deferral of tax liability altogether. *See* George Grayson Tyler & John P. Ohl, *The Revenue Act of 1934*, 83 U. PA. L. REV. 607, 625 (1935). Tyler was the former assistant to Roswell Magill, Assistant to the Secretary of the Treasury, and Ohl was a staff member in the office of the General Counsel to the Secretary of the Treasury. One of the most basic forms of tax avoidance cited by the Subcommittee was that deferral often turned into avoidance when a corporation waited to sell gain assets received in a reorganization during a loss year for the corporation, effectively avoiding tax altogether. *See* SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 8-9 (Comm. Print 1933), *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 31.

190. *See* SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 8-9 (Comm. Print 1933), *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 31; *see also* Comment, *supra* note 156, at 140 n.41 (citing another study on revenue revision in which the Subcommittee concluded that "the abuses under the present policy far outweigh the advantages").

191. *See* SUBCOMM. OF THE HOUSE COMM. ON WAYS AND MEANS, 73D CONG., 2D SESS., PRELIMINARY REPORT ON PREVENTION OF TAX AVOIDANCE 9 (Comm. Print 1933), *reprinted in* 100 U.S. REVENUE ACTS, *supra* note 31.

192. *See* STATEMENT OF THE ACTING SECRETARY OF THE TREASURY, *supra* note 188, at 10.

when the reorganization exemption was seen as a vital aid to business recovery. After the stock market crash of 1929 and the ensuing onset of the Great Depression, many profitable enterprises became loss corporations seeking to recognize such losses. The Acting Treasury Secretary noted that since many reorganizations were being effected by struggling corporations, "[t]he immediate result of abolishing the reorganization provisions would be to permit the thousands of bondholders and stockholders of such organizations to establish losses, even though they obtain and retain securities in a new enterprise which is substantially the same as their original investment."[193] In fact, Congress heard testimony that several reorganizations pending at the time that the House Subcommittee's recommendations were being debated would give rise to loss recognition if they were made taxable.[194] The problem with this argument, however, was that the Revenue Act of 1934 adopted limits on the recognition of capital losses that effectively eliminated any incentive to recognize losses through reorganizations.[195] Furthermore, given the technical hoops set up in the 1934 Act for reorganizations to receive nonrecognition treatment, this argument ignored the likelihood that many taxpayers would fall outside the statute and be forced to realize their losses under other provisions of current law.[196] The more persuasive reason offered by the Acting Secretary for the preservation of the exemption was that, in the case of many business transactions, the exemption was consistent with Congress's understanding of realization and it was beneficial to business readjustments.[197] Furthermore, the fact that many reorganizations then occurring involved loss corporations meant that the exemption did not contribute greatly to tax avoidance.[198] In any

193. *Id.* Although this argument was not made at the time, a taxpayer's ability to create losses is currently cited as one of the failings of a realization test for income taxation. *See* Daniel Halperin, *Saving the Income Tax: An Agenda for Research*, 97 TAX NOTES 967, 969 (1997).

194. *See* 78 CONG. REC. 2512 (1934) (letter from H. Morgenthau, Jr., Secretary of the Treasury, to Rep. Robert L. Doughton, Chairman of the House Committee on Ways and Means (Feb. 12, 1934)).

195. *See* Sandberg, *supra* note 69, at 121.

196. *See id.*

197. *See* STATEMENT OF THE ACTING SECRETARY OF THE TREASURY, *supra* note 188, at 10.

198. *See Revenue Revision 1934: Hearings Before the House Comm. on Ways & Means*, 73d Cong. 76 (1933) (statement of Roswell Magill, Assistant to the Secretary of the Treasury Department) ("[O]ur suggestion is we do not think you will lose much in the next year by leaving things in the way they are, in view of the fact that there are not many reorganizations going through now which would show a profit.").

event, Treasury recommended revising the provisions rather than abolishing them.

B. 1934 and the Institution of a Statutory Merger Requirement

In the Revenue Act of 1934, Congress undertook the first wholesale revision of the reorganization provisions in a decade.[199] The goal was to "stop the known cases of tax avoidance," while at the same time permitting "legitimate reorganizations, required in order to strengthen the financial condition of the corporation" to continue without tax.[200] The House Ways and Means Committee therefore proposed cutting back on the number of transactions in which a reorganization exemption was available. Under the House proposal, the definition of reorganization was designed to "conform more closely to the general requirements of corporation law."[201] Thus, under this proposal, only "(1) statutory mergers and consolidations; (2) transfers to a controlled corporation, 'control' being defined as an 80 per cent ownership; and (3) changes in the capital structure or form of organization" would be classified as reorganizations.[202] This first appearance of a statutory merger requirement reflected both a federal embrace of state corporate law protections and a suspicion of the role business combinations played in the onset of the stock market crash and the Great Depression.

1. Use of State Corporation Laws to Protect Against Abuse

The desire to conform the reorganization provisions with corporation law by exempting only mergers effected under the authority of a state or the federal government was a seemingly redundant exercise. As James Fahey pointed out soon after the requirement was enacted, "[i]t is well established that corporations cannot lawfully consolidate or merge without the consent of the legislature from which they received their charters."[203] Underlying

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199. *See* Revenue Act of 1934, ch. 277, 48 Stat. 680.

200. H.R. REP. NO. 73-704, at 13, 14 (1934), *reprinted in* 1939-1 C.B. (pt. 2), at 564; *see also* Dana Latham, *Taxation of Capital Gains, Tax Avoidance and Other Problems Under the Revenue Act of 1934*, 23 CAL. L. REV. 30, 41 n.39 (1934) (suggesting that the statutory merger requirement was designed to stem the loss of taxes caused by reorganizations during the Depression).

201. H.R. REP. NO. 73-704, at 14, *reprinted in* 1939-1 C.B. (pt. 2), at 564.

202. *Id.* The first requirement conforms to the present day A reorganization. *See* I.R.C. § 368(a)(1)(A). The second requirement conforms to an organization of a new corporation under § 351. *See id.* § 351(c)(2). The third requirement conforms to an E reorganization. *See id.* § 368(a)(1)(E).

203. Fahey, *supra* note 64, at 947; *see also* ARNOLD R. BAAR & GEORGE MAURICE

this doctrine was the long-held belief that a corporation is a creature of the state and derives its power and authority, including any right to merge or consolidate, through a grant or concession by the state.[204] In Roman times, religious bodies and feudal organizations such as communes and guilds were "rivals" of the state in its claim to complete sovereignty.[205] In order to bolster its claims, the State sought to treat all such lesser bodies as " 'conjurations' and conspiracies," unless they operated under an express grant of authority from the state.[206] England eventually relied on similar principles to justify its regulation and use of private trading companies for public diplomatic functions.[207] Although this theory was not as prevalent by the early twentieth century as it once was, it was still a part of the intellectual fabric when the reorganization

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MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS 32 (1935) (noting that it was only by statute that corporations had any power to consolidate or merge, even before the 1934 Act); George S. Hills, *Definition—"Reorganization" Under the Revenue Act of 1934*, 12 TAX MAG. 411, 411 (1934) ("The insertion of the word 'statutory' before 'merger or consolidation' adds nothing to the intentions or requirements of corporation law."); Taylor, *supra* note 40, at 695 (noting that corporate combinations were not allowed at common law, but only through state enabling statutes); Comment, *supra* note 156, at 141 ("Since a merger or consolidation is necessarily statutory, Congress has here not introduced any additional restriction, but has merely indicated more clearly the meaning to be attached to 'merger or consolidation.' "); Comment, *supra* note 40, at 108 (describing an attempt at merger or consolidation without such authorization as an "absolute nullity"). One commentator has speculated that the insertion of the term "statutory" was intended to free courts from the task of explaining why all mergers had to be effected pursuant to a state or federal statute. *See* HOLZMAN, *supra* note 65, at 67.

204. *See* BAAR & MORRIS, *supra* note 203, at 32 ("[I]t is only by virtue of a statute that corporations have any authority to merge or consolidate. Corporations are created, live and cease to exist, solely by statutory authority. Any changes in their structure which affect their continued existence or their demise are, consequently, matters of statutory prescription."). *See generally* WILLIAM L. CLARK, HANDBOOK OF THE LAW OF PRIVATE CORPORATIONS § 1, at 3 (2d ed. 1907) (describing a corporation as a "mere creature of law"); HORWITZ, *supra* note 35, at 112 (noting that this state-created conception began with the archetypal eighteenth-century American corporation as a municipality charged with carrying out public functions and only slowly developed to assume private interests); NOYES, *supra* note 92, § 11, at 15 (stating that mergers and consolidations are merely transfers of property and rights from one corporation to another "in existence with the [surviving corporation's] original powers").

205. *See* John Dewey, *The Historic Background of Corporate Legal Personality*, 35 YALE L.J. 655, 666 (1926).

206. *Id.*; *see also* JAMES WILLARD HURST, THE LEGITIMACY OF THE BUSINESS CORPORATION IN THE LAW OF THE UNITED STATES, 1780-1970, at 2 (1970) ("To maintain central authority over diverse potential competitors, the Roman state and the church at times found it expedient to declare that legally effective corporate being required an act of the civil or religious sovereign—or at least a license.").

207. *See* GERARD CARL HENDERSON, THE POSITION OF THE FOREIGN CORPORATIONS IN AMERICAN CONSTITUTIONAL LAW 11 (1918); HURST, *supra* note 206, at 2-4; LATTIN, *supra* note 101, at 174-75.

provisions were first adopted. In 1918, Professor Ernst Freund observed that "there is no capacity to act as a body corporate without positive authorization."[208] Since a consolidation involved the creation of a new corporation and both a merger and a consolidation involved the transfer of one or more corporation's franchises to another corporation, legislative authorization was seen as a prerequisite for according legal effect to the change.

Applying this doctrine, courts refused to recognize or give effect to mergers lacking statutory or legislative authorization. In *Pearce v. Madison & Indianapolis Railroad Co.*,[209] the Supreme Court rejected the claims of an assignee of certain notes who argued that since the notes were signed by the joint management of a formerly consolidated railroad corporation, each corporation was liable on the notes after the consolidated corporation separated.[210] According to the Court, the original execution of the notes was ultra vires since "[t]here was no authority of law to consolidate these corporations, and to place both under the same management, or to subject the capital of the one to answer for the liabilities of the other."[211] Similarly, in *Topeka Paper Co. v. Oklahoma Publishing Co.*,[212] the Supreme Court of Oklahoma held that because the attempted consolidation of two corporations to form The Oklahoma City Publishing Company was "not authorized by any provision of the statutes," a creditor could maintain its claim against one of the corporations.[213] According to the court, "[i]n the absence of any statute authorizing the consolidation which was attempted, the legal rights of the creditors of the defendant corporation and its legal liabilities and those of the directors remain the same."[214] Thus, a legislative authorization requirement appeared to be redundant because a merger or consolidation was only legal if effected pursuant to some sovereign authority.

One distinction between the statutory merger and an ordinary merger, however, was that the term "statutory merger" excluded

208. ERNST FREUND, STANDARDS IN AMERICAN LEGISLATION 39 (1917), *reprinted in* Dewey, *supra* note 205, at 667.

209. 62 U.S. (1 How.) 441 (1859).

210. *See id.* at 442.

211. *Id.* at 443.

212. 54 P. 455 (Okla. 1898).

213. *Id.* at 456.

214. *Id.*; *see also* Central R.R. & Banking Co. v. Georgia, 92 U.S. 665, 675 (1876) (holding that in a merger, the surviving corporation takes the assets of the merged corporation "just as they were, acquiring no additional or enlarged rights as against the State").

mergers effected pursuant to authority contained in a corporation's charter or some other non-statutory legislative authorization.[215] As a treatise writer noted at the turn of the century, "[a] grant of power to consolidate contained in the charters of the constituent corporations . . . furnishes undoubted authority" to consummate the transaction.[216] In the first half of the nineteenth century, corporations were created through a special act of the legislature outlining the rights, powers, and obligations of the new corporation, including the right to merge or consolidate.[217] Originally, the vast majority of such "special charters" were granted for quasi-public enterprises such as bridge, canal, or turnpike companies.[218]

Because of the public benefit associated with such ventures, their special charters were often accompanied by a grant of explicit or implicit subsidies.[219] While these special charters were necessary during the development of the country and its infrastructure, they came to be seen by Jacksonians as " 'special privileges' or 'partial laws' that violated 'equal rights,' corrupted state legislators, and created new forms of aristocracy."[220] State legislatures turned to

215. *See* Fahey, *supra* note 64, at 947 ("The wording of Part (A) indicates that only those consolidations or mergers which have been carried out pursuant to 'statutory' authority, as contrasted with a charter provision, are included within the scope of this clause of the definition.").

216. NOYES, *supra* note 92, § 20, at 27.

217. *See* FRIEDMAN, *supra* note 104, at 188; HAROLD F. LUSK, BUSINESS LAW: PRINCIPLES AND CASES 694 (3d ed. 1946). Initially, special acts were sought at the time of merger or consolidation. *See* Comment, *supra* note 40, at 109 ("At the time the merger and consolidation device originated, corporations were created solely by special legislative acts. Consequently, the earliest sources of the power to merge or consolidate were also special acts."). Soon, however, incorporators began to plan ahead and insert provisions in their special charters authorizing the merger or consolidation of the corporation on their own initiative. *See id.*

218. Professor Willard Hurst found that nearly two-thirds of the 317 state special charters granted for specific lines of business between 1780 and 1801 were for transportation businesses such as inland navigation, turnpikes, and toll bridges, 20% for banks or insurance companies, and 10% were for the provision of local services such as water or other utilities. *See* HURST, *supra* note 206, at 17. Less than 4%, however, were for general business or manufacturing corporations. *See id.*

219. *See* Herbert Hovenkamp, *The Classical Corporation in American Legal Thought*, 76 GEO. L.J. 1593, 1609 (1988).

220. Note, *Incorporating the Republic: The Corporation in Ante Bellum Political Culture*, 102 HARV. L. REV. 1883, 1893 (1989) [hereinafter *Incorporating the Republic*] (citations omitted); *see also* Taylor, *supra* note 40, at 750 (noting that such acts were perceived as the products of political favoritism); Note, *The Corporation and the Constitution: Economic Due Process and Corporate Speech*, 90 YALE L.J. 1833, 1844 (1981) (finding that special charters came to be viewed as corrupt opportunities to convey significant economic benefits on the few). This attitude extended to those outside the Jacksonian movement. Amasa Walker, a Free Soiler and Republican, argued at the Massachusetts Constitutional Convention of 1853 that "this system of corporations is

general incorporation statutes, which served as enabling acts and thus did not require the passage of a special act of incorporation, in order to open up the incorporation process to more people.[221] The special charter system was scrapped or limited by several states to avoid what Justice Brandeis referred to as "the scandals and favoritism incident to special incorporation."[222] This did not mean, however, that no special charters were issued, or that corporations formed under special charters did not continue to operate well into the twentieth century. Although the first truly "general" incorporation statute was enacted as early as 1837 by Connecticut[223] and general incorporation statutes began to dominate after the 1870s,[224] special charters were still issued in many states when the corporate aims could not be attained under the general laws.[225] The issuance of special charters was often used to permit certain corporations to obtain advantages not provided for in the general incorporation and merger statutes. In 1892, for instance, New York issued a special charter to the General Electric Co. to prevent its reincorporation in New Jersey, a state with a more favorable corporation law, and, as late as 1952, a special charter was issued to a variable annuity company, the College Retirement Equities Fund.[226] Moreover, unincorporated companies and associations, such as business trusts, joint-stock companies, and insurance companies, could only rely on their charters as a source of authority for their right to merge or

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nothing more nor less than a moneyed feudalism." ERIC FONER, FREE SOIL, FREE LABOR, FREE MEN: THE IDEOLOGY OF THE REPUBLICAN PARTY BEFORE THE CIVIL WAR 22 (1970).

221. *See* Theodore H. Davis, Jr., Comment, *Corporate Privileges for the Public Benefit: The Progressive Federal Incorporation Movement and the Modern Regulatory State*, 77 VA. L. REV. 603, 611 n.36 (1991).

222. Louis K. Liggett Co. v. Lee, 288 U.S. 517, 549 (1933) (Brandeis, J., dissenting).

223. *See* Act of June 10, 1837, ch. 63, 1837 Conn. Pub. Acts 49. Connecticut's act was the first to apply to corporations formed for "any lawful purpose" rather than for a specific industry. *Incorporating the Republic*, *supra* note 220, at 1883 & n.2. New York and New Jersey both enacted limited statutes in the beginning of the nineteenth century for the purpose of authorizing general incorporation in manufacturing industries. *See* Taylor, *supra* note 40, at 751.

224. *See* HURST, *supra* note 206, at 37; Davis, *supra* note 221, at 613 n.47.

225. *See* HARRY G. HENN, HANDBOOK OF THE LAW OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES 17 (1961); *see also* FRIEDMAN, *supra* note 104, at 512 (noting that special charters were not supposed to be issued unless corporate goals could not be realized otherwise); HURST, *supra* note 206, at 33 (noting that corporation law was primarily a form of social regulation of business behavior).

226. *See* HENN, *supra* note 225, at 17 n.14; *see also* Bisbee, *supra* note 40, at 404 (reporting that a corporate client of Bisbee's firm that had been organized in the eighteenth century continued to seek special legislative authority for actions that were otherwise covered by the general incorporation act).

consolidate. While the Revenue Acts had generally taxed such associations as corporations, state merger statutes rarely provided them a right to engage in mergers or consolidations.[227] Instead, such powers were normally included within the association's charter.[228] As one contemporary treatise observed, "[i]f it be insisted, therefore, that mergers and consolidations are inherently statutory, such enterprises as associations which lack authority, under state laws, to merge or consolidate, could not reorganize by such route."[229]

Permitting statutory mergers, but not mergers effected pursuant to authority granted in a corporation's charter or mergers conforming to a common law tax definition, to qualify for nonrecognition treatment reflected a general congressional sentiment regarding the significance of state corporation law in the regulation of mergers and consolidations. Historically, fundamental corporate changes required strict compliance with certain statutory restrictions before receiving a State's blessing. Such restrictive conditions included a requirement that the parties engage in the same or similar businesses, that the target shareholders acquire an equity or other permanent interest in the acquirer, and that the target corporation dissolve after the completion of the merger or consolidation.[230] These corporate law requirements became the basis for the doctrines that there must be continuity of business enterprise, continuity of shareholder interest, and dissolution of the "merged" entity in order to qualify for tax-free treatment under the parenthetical clause.[231] These doctrines were premised on the theory that a transaction did not resemble or partake of the nature of a merger or consolidation if it did not follow those three underlying corporate law requirements for a merger or consolidation.[232]

227. *See* BAAR & MORRIS, *supra* note 203, at 33.

228. *See id.*

229. *Id.* Baar and Morris suggested that one possible answer to the dilemma of the unincorporated association was to interpret the "however effected" language, as courts had done before, as an expansion of the technical reorganization to cover de facto mergers and consolidation. *See id.* (discussing the language of what is now I.R.C. § 368(a)(1)(F) (West Supp. 1998)).

230. *See* David S. Miller, *The Devolution and Inevitable Extinction of the Continuity of Interest Doctrine*, 3 FLA. TAX REV. 187, 192 (1996); Taylor, *supra* note 40, at 760, 762 (discussing the similar business and stock consideration requirements).

231. *See, e.g.*, Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-40 (2d Cir. 1932) (noting that the "general purpose" of all state merger statutes "has been to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form" and that the reorganization provisions must be read in light of these provisions); *supra* notes 159-87 (discussing corporate law requirements).

232. *See* BAAR & MORRIS, *supra* note 203, at 29; Satterlee, *supra* note 28, at 644-45.

Although courts initially applied all three doctrines to determine the tax treatment of a transaction,[233] the Supreme Court eventually rejected the dissolution requirement in a series of cases by allowing tax-free treatment of asset or stock transfers that stopped short of technical or "true" mergers or consolidations.[234] Dissolution was still thought to be required, however, in the context of a statutory merger or consolidation.[235] Thus, when adopted, the statutory merger requirement was a way of forcing dissolution in transactions attempting to qualify for the more lenient A reorganization treatment.

In addition to providing a baseline definition of merger or consolidation, state corporation laws were thought to provide certain protections for dissenting shareholders and creditors of the merged corporations.[236] Dissenting shareholders have always been accorded special protections by the common law. The former rule of unanimous shareholder consent had meant that no stockholder of the target corporation, no matter how small his interest in the company, could be forced to become a stockholder of the surviving corporation.[237] When the requirement of shareholder unanimity disappeared from the statutes and judicial doctrine, this general principle was modified so that while dissenters could not block a merger or consolidation in the absence of fraud or illegality, they could sue for the value of their shares under a statutory appraisal

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233. *See, e.g.*, *Cortland Specialty Co.*, 60 F.2d at 939-40; Minnesota Tea Co. v. Commissioner, 28 B.T.A. 591, 593-94 (1933); BAAR & MORRIS, *supra* note 203, at 71–72 & n. 95 (collecting Board of Tax Appeals cases that followed the *Minnesota Tea Co.* decision and imposed a dissolution requirement prior to the Supreme Court's resolution of the issue).

234. *See* MONTGOMERY, *supra* note 160; *see also* Robert N. Miller, *Income Tax Liability in Reorganizations*, 14 TAX MAG. 131, 131-32 (1936) (discussing the cases that rejected the dissolution requirement).

235. *See* Pillar Rock Packing Co. v. Commissioner, 34 B.T.A. 571, 574 (1936) (imposing a dissolution requirement on a statutory merger, while acknowledging that such a requirement did not apply to other types of reorganizations); Hendricks, *supra* note 71, at 1217.

236. Although most states had liberalized their corporation law statutes by the 1920s, courts often kept a tight grip on the interpretation of such statutes to preserve the original protections. *See* Norman D. Lattin, *Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders*, 30 MICH. L. REV. 645, 664-65 (1932); Weiss, *supra* note 72, at 631.

237. *See* NOYES, *supra* note 92, § 64, at 104; Comment, *supra* note 40, at 112. This doctrine was rooted in the belief that a shareholder's property interest and contractual relationship with the firm constituted a vested right deserving of protection. *See* Cecile C. Edwards, *Dissenters' Rights: The Effect of Tax Liabilities on the Fair Value of Stock*, 6 DEPAUL BUS. L.J. 77, 83 (1993).

remedy.[238] As discussed previously, this breakdown in the shareholder unanimity requirement was one of the original developments leading to the adoption of nonrecognition treatment for reorganizations,[239] and the appraisal remedy was one of the attempts to remedy the perceived inequity under corporate law of forcing dissenters to accept the consideration offered.[240] By the time the statutory merger requirement was adopted in the Revenue Act of 1934, virtually all state merger and consolidation statutes contained such appraisal provisions, although relief under these provisions could only be invoked by strict compliance with the terms of such statutes.[241] In many jurisdictions, this statutory remedy emerged not merely as an alternative to the unanimous shareholder consent requirement, but as a replacement for any common law remedy previously afforded to dissenting shareholders, such as a direct action at law for conversion of one's shares or in equity for an unconsented taking.[242] By requiring mergers to be statutory in order to qualify as tax-free mergers, Congress signaled its desire to condition favored tax treatment on the existence of state corporate law's protection of nonconsenting shareholders.[243]

State corporate law also served to protect the interests of any creditors of the parties seeking to merge or consolidate. During the mid- to late-nineteenth century, the judiciary protected corporate creditors as part of its general reverence for the law of private contracts.[244] In fact, until 1934, the Supreme Court struck down all attempts to modify retroactively a creditor's ability to enforce its

238. *See* Cole v. National Cash Credit Ass'n, 156 A. 183, 187 (Del. Ch. 1931) (determining no fraud and therefore refusing to enjoin a proposed merger); Taylor, *supra* note 40, at 737; James Vorenberg, *Exclusiveness of the Dissenting Stockholder's Appraisal Right*, 77 HARV. L. REV. 1189, 1194 (1964); Comment, *supra* note 40, at 114-16, 120.

239. *See supra* text accompanying notes 71-78.

240. *See* Comment, *supra* note 40, at 121.

241. *See id.* at 120.

242. *See id.* at 121. Courts refused to recognize an alternative to the appraisal remedy because to do so would sanction dissenters' noncompliance with the statutory requirements and increase uncertainty for the parties as to the appropriate means of satisfying the claims of minority shareholders. *See id.*

243. Although the introduction of the appraisal remedy would appear to obviate one of the original motivating factors for the adoption of nonrecognition treatment for mergers and consolidations, it still did not address the shareholder who did not favor the transaction, but also did not wish to recognize tax from the sale of the stock at that time. Such a stockholder continued to need nonrecognition protection to avoid a forced tax bill.

244. *See, e.g.*, FRIEDMAN, *supra* note 104, at 537-38; L.A. Powe, Jr., *Rehearsal for Substantive Due Process: The Municipal Bond Cases*, 53 TEX. L. REV. 738, 742 (1975) (discussing the Court's desire to uphold the principle of bondholder reliance during the period).

substantive right to repayment that affected more than merely the remedy available to the creditor.[245] Judicial remedies, however, had proven less than complete in protecting creditors.[246] Absent the purchasing company's agreement to assume the obligations of the selling company, the latter's creditors were potentially left with uncertain recourse.[247] To resolve these gaps and inadequacies in the protection of creditors, state merger statutes effected the transfer of the merged company's debts and liabilities by operation of law. As one contemporary commentator noted, "[b]y a merger or a consolidation the creditors of the merging or consolidating corporations cannot be deprived of their right to have access to the property of such corporations for the payment of their claims."[248] The statutory merger requirement thus served to limit tax-free treatment to those transactions in which creditors were protected against the possibility of a disappearing debtor.

The House's proposal to limit tax-free reorganizations to statutory mergers was part of a larger effort, as evidenced by the similar move in the Securities Act, to tie federal benefits to compliance with state corporation law. During the period that the reorganization provisions were made to conform to corporation law, federal securities law relied on corporate law as well. When the Securities Act of 1933 was adopted, a "no sale" theory was developed to explain exemptions from registration for certain mergers, consolidations, and reorganizations.[249] Originally, the Federal Trade Commission ("FTC"), the administrator of the Act in the year prior

245. *See* Hovenkamp, *supra* note 219, at 1613. In 1934, the Court handed down its decision in *Home Building & Loan Ass'n v. Blaisdell*, 290 U.S. 398 (1934), in which it upheld a statute passed during the heart of the Depression that placed a moratorium on mortgage foreclosures. *See id.* at 444-48.

246. *See, e.g.*, McAlister v. American Ry. Express Co., 179 N.C. 556, 560-61, 103 S.E. 129, 130-31 (1920); Comment, *Rights of Creditors Against a Successor Corporation*, 44 HARV. L. REV. 260, 264 (1930). *But see* American Ry. Express Co. v. Commonwealth, 228 S.W. 433 (Ky. 1920) (holding that the sale of all of a company's assets in exchange for the stock of another company was fraudulent with respect to the company's creditors because shares were not adequate consideration for the assets).

247. *See* LATTIN, *supra* note 101, at 619. For example, in equity, creditors were only protected to the extent of the value of the assets held by the selling corporation prior to transfer, not the extent of the value of the debt itself or to the extent of the value of future earnings. *See* LUSK, *supra* note 217, at 803; Comment, *supra* note 246, at 261 ("Cash and stock are easily concealed and readily taken out of the jurisdiction; and the transferee's promise to pay money may be enforced only by an additional equitable or statutory proceeding. This is equally true of an assumption of liability, except where third party beneficiaries are allowed to sue.").

248. LUSK, *supra* note 217, at 803.

249. *See generally* 1 LOSS, *supra* note 38, at 518 (discussing the origin of the "no sale theory").

to the creation of the Securities and Exchange Commission ("SEC"), took the position that such transactions were sales for which registration was required.[250] The FTC created Form E-1 for the registration of securities "sold" in reorganizations and defined "reorganization" to include a "statutory merger or consolidation" in Rule 5, which explained the use of Form E-1.[251] After the American Bar Association ("ABA") suggested the expansion of the exemption from registration to include mergers, consolidations, and reorganizations, the newly created SEC amended Rule 5 to require the registration of only non-statutory mergers or consolidations.[252] In a Note to Rule 5, the SEC deemed " 'no sales to stockholders of a corporation to be involved . . . where [there is] a plan or agreement for a statutory merger or consolidation, provided the vote of a required favorable majority' would operate to authorize the transaction and bind all stockholders except for appraisal rights of dissenters."[253] The theory underlying this no sale provision, much like the theory favoring nonrecognition treatment when an exchange of stock occurs in a merger, was that a shareholder should not be deemed to have sold his interest when the exchange occurs by virtue of state law rather than individual action.[254] Since statutory mergers were subject to the approval of a majority of shareholders and provided certain protections for dissenting shareholders and creditors, while nonstatutory mergers involved a certain element of voluntariness, the SEC determined that only the latter constituted a sale subject to the registration requirements.[255] Thus, federal reliance

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250. *See id.* at 519.

251. *Id.*, at 519-20 (quoting Rule 5 as to the Use of Form E-1, Securities Act Release 167 (1934)).

252. *See id.* at 520. The SEC's first general counsel took this position before it was formally introduced as an amendment to Rule 5. *See* A.A. Sommer, Jr., *Mergers, Consolidations, Sales of Assets—Rule 133, in* ABA SECTION OF CORPORATION, BANKING AND BUSINESS LAW, SELECTED ARTICLES ON FEDERAL SECURITIES LAW 279, 282 (Herbert S. Wander & Warren F. Grienenberger eds., 1968).

253. 1 LOSS, *supra* note 38, at 520 (quoting Adoption of Form E-1, Securities Act Release No. 493(c), 1 Fed. Sec. L. Rep. (CCH) ¶ 3090.566 (Sept. 20, 1935)).

254. *See* 1 *id.* at 521; *see also* RICHARD W. JENNINGS & HAROLD MARSH, JR., SECURITIES REGULATION: CASES AND MATERIALS 310 (5th ed. 1982) (explaining the Rule 133 requirement that "the submission of the acquisition transactions to the vote of shareholders is not deemed to involve a 'sale' or 'offer to sell' ").

255. Rule 133 of the Securities Act of 1933, which embodied the no sale rule, was rescinded in 1972 and replaced with Rule 145 requiring the registration of securities issued in connection with a reorganization. *See* Notice of Adoption of Rules 145 & 153A, Securities Act Release No. 5316, [1972-1973 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 79,015 (Oct. 6, 1972), *reprinted in* JAMES D. COX ET AL., SECURITIES REGULATION: CASES & MATERIALS 534 (1991).

on state corporation law extended beyond the federal tax system.

2. Limit Excessive Business Combinations in Response to the 1929 Stock Market Crash

The House's proposal to limit tax-free reorganizations to statutory mergers and a few other narrow transactions was also prompted by a general desire to limit the excessive business combinations thought to be responsible for the Stock Market Crash of 1929. The post-World War I economic boom that triggered the rapid increase in the number of mergers and acquisitions discussed earlier was slowed by the depression of 1921.[256] During the economic prosperity of the mid- to late 1920s, business combinations again picked up. Of the ninety-two active holding companies whose stock was listed on the New York Stock Exchange in 1928, seventy-seven had been granted charters since 1910, and of those companies, at least thirty-four had received their charters between 1923 and 1928.[257] Furthermore, during 1928 and 1929, mergers occurred at a far more rapid pace than at the beginning of the decade or at any time during the merger movement at the turn of the century.[258] Of the 8500 formerly independent manufacturing and mining businesses that were acquired between the end of World War I and the end of 1931, more than 4800 were acquired between 1926 and 1930 and almost 2300 disappeared in 1928 and 1929 alone.[259]

Economic concentration accompanied this revived period of merger and consolidation. Between 1922 and 1929, there were eight mergers valued at over $100 million and at least fourteen transactions in which the target corporation had assets valued at over $50 million.[260] By 1933, Justice Brandeis reported that "the process of absorption has already advanced so far that perhaps two-thirds of our industrial wealth has passed from individual possession to the ownership of large corporations whose shares are dealt in on the stock exchange."[261] According to Justice Brandeis, 200 non-banking corporation, each possessing assets of over $90 million directly controlled about one-fourth of the nation's wealth.[262] One study

256. *See* BUTTERS ET AL., *supra* note 39, at 292.

257. *See* ADOLF A. BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 204 n.18 (1932).

258. *See* BUTTERS ET AL., *supra* note 39, at 292.

259. *See id.*

260. *See id.* at 294.

261. Louis K. Liggett Co. v. Lee, 288 U.S. 517, 565 (1933) (Brandeis, J., dissenting) (citing BERLE & MEANS, *supra* note 257, at vii).

262. *See id.* at 566 (Brandeis, J., dissenting).

concluded that the merger movement in the 1920s not only significantly increased economic concentration but did so "to a substantial extent" in certain key industry groups.[263]

After the stock market crash in October of 1929, which quickly ended the "seemingly indefinite prosperity" of the post-World War I era,[264] popular opinion attributed much of the blame for the crisis to the "excessive" business combinations and resulting economic concentration of the 1920s.[265] As Paul Conkin reports, this blame was probably misplaced: "Numerous corporate consolidations increased efficiency even as they narrowed participation in key managerial choices."[266] The broad impact of the crash, however, made this reality irrelevant for a Congress seeking to blunt its bitter effects, as "[t]he statutes which 'permitted necessary business adjustments' in 1921" became from the post-Crash perspective of the 1930s, "one of the major and indispensable forces in the thrust towards economic concentration which characterized the 'twenties.' "[267]

Some of this popular backlash against the merger movement was attributable to the personal losses suffered by the stock market's relative newcomers. The stockholdings of those masses who entered the market during the rising tide of the 1920s quickly turned sour after the crash. On September 1, 1929, the aggregate value of all stocks listed on the New York Stock Exchange was $89 billion.[268] Within a month, that number had fallen by $18 billion and by 1932, the aggregate number had dropped to $15 billion—a loss of $74 billion in value over the course of two and one-half years.[269] The acute shock of the crash, coupled with the long, hard years of the Depression, led to a series of reform measures. Such measures included the Securities Act of 1933, the Securities Exchange Act of 1934, the Glass-Steagall Act of 1933, and a variety of tax law changes.[270] Thus, the stock market crash and ensuing depression, both because they reduced some of the original pressure from new

263. BUTTERS ET AL., *supra* note 39, at 299 (discussing increased concentration in industry groups such as oil, steel, and copper).

264. 1 LOSS, *supra* note 38, at 120.

265. *See Louis K. Liggett Co.*, 288 U.S. at 566-67 (Brandeis, J., dissenting) ("Other writers have shown that, coincident with the growth of these giant corporations, there has occurred a marked concentration of individual wealth; and that the resulting disparity in incomes is a major cause of the existing depression.").

266. PAUL K. CONKIN, THE NEW DEAL 24 (3d ed. 1992).

267. Sandberg, *supra* note 69, at 125.

268. *See* 1 LOSS, *supra* note 38, at 120.

269. *See* 1 *id.*

270. *See* 1 *id.* at 121; *see also* Investment Co. Inst. v. Camp, 401 U.S. 617, 629 (1971) (discussing the Glass-Steagall Act).

stockholders for a reorganization exemption and because reorganizations received some of the blame for the spate of overspeculation and concentration leading up to the crash, led the House to pass a bill severely limiting the availability of nonrecognition treatment by restricting the reorganization exemption to statutory mergers.

3. Expansion to Include Other Forms of Reorganizations

Although the Senate Finance Committee stated that it was "in complete agreement with the purposes of the House bill which aim at tax-avoidance," it sought to expand the scope of the reorganization exemption to cover transactions not qualifying as statutory mergers.[271] The Committee agreed with the Treasury that "some legitimate and desirable business readjustments would be prevented" absent nonrecognition treatment for certain reorganizations.[272] For the Senate, such "legitimate and desirable business readjustments" included a wider array of transactions.[273] Thus, in addition to the statutory merger or consolidation requirement necessary for an A reorganization, the final version of the Revenue Act included a Senate amendment:

> (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.[274]

Through these amendments to the House bill, the Senate accepted the restrictions imposed by the statutory merger or consolidation requirement while expanding the number of transactions covered by the exemption.

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271. S. REP. NO. 73-558, at 16 (1934), *reprinted in* 1939-1 C.B. (pt. 2), at 586, 598.

272. *Id.* at 17, *reprinted in* 1939-1 C.B. (pt. 2), at 599.

273. *Id.*, *reprinted in* 1939-1 C.B. (pt. 2), at 598.

274. Revenue Act of 1934, ch. 277, § 112(g), 48 Stat. 680, 705. In the Revenue Act of 1939, the phrase "substantially all the properties of another corporation" was removed from clause (B) and placed in a new clause (C), resulting in the relettering of the remaining clauses. *See* George v. Commissioner, 26 T.C. 396, 403 (1956).

One rationale for expanding the reorganization exemption to cover transactions other than statutory mergers was to permit nonrecognition in states without merger or consolidation statutes. According to the Senate Finance Committee, the additional reorganization provisions were necessary "in order to bring about a more uniform application of the provisions in all 48 of the States. Not all of the States have adopted statutes providing for mergers or consolidations; and, moreover, a corporation of one State cannot ordinarily merge with a corporation of another State."[275] By 1935, only thirty-three states and the Territory of Hawaii had general statutes authorizing merger or consolidation, and a special act or charter provision was still required to effect a merger or consolidation in the fourteen remaining states, the District of Columbia, the Philippine Islands, Alaska, and Puerto Rico.[276] Of the jurisdictions permitting mergers or consolidations, only twenty-one authorized the merger or consolidation of a domestic and a foreign corporation, and at least three of these more liberal jurisdictions still required the surviving corporation to be domestic in order to qualify under their respective statutes.[277] Thus, both in the jurisdictions not having any general merger or consolidation statute and in the jurisdictions whose statutes did not authorize the merger of domestic and foreign corporations, there could be no "statutory merger or

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275. S. REP. NO. 73-558, at 16, *reprinted in* 1939-1 C.B. (pt. 2), at 586, 598. Testimony before the Senate Finance Committee during a hearing on the proposed bill may have contributed to the Committee's conclusion. A Report of the Committee on Federal Taxation of the U.S. Chamber of Commerce concluded that since the definitions of merger and consolidation in effect in the jurisdiction in which the transaction took place would govern the classification, "[w]hat would be a merger or consolidation in one State might not be in another. Instead, then, of having uniform principles generally applicable to all corporations, there would be different standards applicable to different corporations." *Hearings on H.R. 7835 Before the Senate Comm. on Fin.*, 73d Cong. 59 (1934) (Report of the Comm. on Federal Taxation, Chamber of Commerce of the United States), *reprinted in* 11 U.S. REVENUE ACTS, *supra* note 31. Similarly, a representative of the Cleveland Chamber of Commerce predicted that "a substantial amount of litigation will be necessary in order to find out just what is and what is not a statutory consolidation or merger." *Id.* at 2-3 (statement of David A. Gaskill of the Cleveland Chamber of Commerce).

276. *See* Fahey, *supra* note 64, at 948; Comment, *supra* note 40, at 110.

277. *See* PAUL, *supra* note 8, at 61; Fahey, *supra* note 64, at 948. Although there was some disagreement as to which states were included on the lists, that does not seem to be attributable to amendments. *Compare* Comment, *supra* note 40, at 110 n.26 (listing Alabama, Arkansas, California, Delaware, Florida, Idaho, Kansas, Kentucky, Louisiana, Maine, Michigan, Montana, Nevada, New Jersey, New York, New Mexico, Pennsylvania, Tennessee, Virginia, and Washington), *with* Fahey, *supra* note 64, at 948 n. 67 (listing 18 states and one territory). Kentucky, Maine, and Virginia explicitly required the surviving corporation to be domestic, and Montana and New Jersey's statutes seem to have imposed a similar requirement. *See* Comment, *supra* note 40, at 110.

consolidation," and therefore no tax-free reorganization, under the House's narrowly drafted reorganization exemption.[278] Moreover, even in a state with a merger statute, if the parties effected a practical merger or consolidation, but failed to comply with all the technical requirements of the statute, nonrecognition treatment was unavailable. The Senate Finance Committee amendments attempted to mitigate these results.[279]

Congress's bad experience with the loosely drafted parenthetical clause from the 1921 Act led the Senate to advocate a more uniform and precise definition of such non-merger transactions. The fact that many states had either no merger statute or a limited one had prompted the Senate to reject the House's proposal to eliminate the parenthetical clause transactions altogether from the reorganization definition. The Senate Finance Committee explained that, in states where no statutory merger or consolidation provision was available or applicable, it believed that it was "desirable to permit reorganizations in such cases, with restrictions designed to prevent tax avoidance."[280] To accomplish this latter goal, the Senate scrapped the old parenthetical clause and separated the various descriptions into their own clauses. Most significantly, in the 1934 Act, the non-statutory mergers specified the required consideration. For a B reorganization acquisition of stock, the transferring corporation had to transfer voting stock constituting control of the corporation or substantially all of the properties of the transferring corporation.[281] Milton Sandberg explained that "Part (B) was claimed to be a loophole-proof substitute for the former parenthetical words of Part (A). Its purpose was to permit readjustments in states which have no statutory system of mergers and consolidations."[282] Speaking on the Revenue Act of 1936, the Committee explained to the rest of Congress that the controlling voting stock requirement was "declaratory of existing law but expresses it in more apt language."[283]

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278. *See, e.g.*, MONTGOMERY, *supra* note 160, at 169; Fahey, *supra* note 64, at 948.

279. *See* Mark Eisner, *Taxation Affecting Corporation Reorganizations*, (noting that in drafting the Revenue Act of 1921 and later acts, "Congress sought to provide for the situation presented where an attempt was made to effectuate a practical merger or consolidation without compliance with the technical requirements of state laws, or where there is no state law, covering the readjustment which has taken place"), *in* SOME LEGAL PHASES OF CORPORATE FINANCING, REORGANIZATION AND REGULATION 403, 419 (1931), *quoted in* Miller, *supra* note 230, at 194.

280. S. REP. NO. 73-558, at 16, *reprinted in* 1939-1 C.B. (pt. 2), 586, 598.

281. *See* Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 680, 705.

282. Sandberg, *supra* note 69, at 117.

283. 80 CONG. REC. 8799 (1936) (statement of Sen. George).

The Senate's decision to draft with specificity resolved a ten-year debate that had begun with the issuance of the Gregg Statement in 1924.[284] At that time, Congress concluded after extensive study that an expansion of the reorganization provisions to detail the precise nature of each requirement was necessary to provide certainty and predictability for taxpayers and thus to avoid the ambiguity and uncertainty of the 1918 Act.[285] However, given the almost inherent ability of creative tax lawyers to exploit loopholes in seemingly explicit language, such efforts at precision soon proved to be ineffective.[286] In its response to the 1933 Ways and Means Committee Report proposing the removal of the reorganization provisions, the Acting Secretary of the Treasury complained that the specificity of the statute contributed to its avoidance:

> In addition to their complexity, [the reorganization provisions] are open to the serious objection of being overspecific. When they were adopted in 1924, the draftsmen attempted to state in minute detail exactly how each step of a reorganization should be treated for tax purposes. Although this method had the apparent advantage of enabling taxpayers and their lawyers to determine in advance exactly how proposed transactions would be taxed, it had the disadvantage of leaving the Department no leeway in the administration of the law. Consequently, astute lawyers could and did arrange what were really sales to take the technical form of a reorganization within the statutory definition, with resultant loss of revenue.[287]

Thus, Treasury proposed that the provisions should be redrafted so as to "express in the statute as simply as possible the general plan for dealing with these transactions, leaving to the Department as in other cases the power to make rules and regulations to carry out the

284. The "Gregg Statement'" is the popular name for a report prepared by A.W. Gregg, then-Special Assistant to the Secretary of the Treasury. *See* MAGILL, *supra* note 63, at 128 n.11.

285. *See* PAUL, *supra* note 8, at 37; *see also* Brookes, *supra* note 9, at 5 (stating that the 1924 Act reorganization provisions "were probably the most detailed and precise statutes which had been evolved up to that time"). The Gregg Statement, thought to be the origin of the 1924 Act, advocated specific and all-encompassing provisions designed to provide certainty and predictability, while the Treasury Department advocated flexible provisions enabling it to provide appropriate interpretations as specific situations arose. *See* Satterlee, *supra* note 28, at 640.

286. *See* PAUL, *supra* note 8, at 37.

287. STATEMENT OF THE ACTING SECRETARY OF THE TREASURY, *supra* note 188, at 9.

congressional intent."[288] Congress, however, chose the path of greater rather than less specificity in adopting the final reorganization provisions in 1934.[289]

C. *The Judicial Evisceration of the Statutory Merger Requirement*

When Congress originally adopted the statutory merger requirement, it was suggested that the judicial doctrines of continuity of interest and business enterprise would be inapplicable. Calvin Johnson points out that "[i]n 1934, there was plausibly nothing in the continuity-of-interest doctrine that would not be satisfied by qualification as a state-law merger."[290] Congress, by not placing the same restrictions on consideration that it imposed upon B reorganizations, appeared to assume that state law would impose such limitations as conditions for the qualification of a transaction as a merger or consolidation.[291] As Roswell Magill reported, "it has been argued that Congress, when it amended the reorganization definition in 1934 to include 'a *statutory* merger or consolidation,' showed an intent to consider such a statutory procedure as in itself providing the necessary continuity of interest."[292] Moreover, even if state law did not automatically offer the protections enacted by Congress for the other types of reorganizations, some observers argued that such protections should be unnecessary in the context of statutory mergers or consolidations.[293] One commentator noted that the continuity of interest requirement "was formulated in order to determine whether a transfer of substantially all the assets of a corporation sufficiently resembled a merger and consolidation when it technically was not such, and when the transaction fully satisfies every formal requisite of a true merger or consolidation, the standard is unnecessary."[294] Because the judicial doctrines had been created to close a loophole in the 1921 Act's parenthetical clause that had long

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288. *Id.* at 10.

289. As Randolph Paul described it, "[a] confused Congress refused to follow the Treasury's desperate recommendation, and preferred Llewellyn's advice: 'No cure for law but more law.'" PAUL, *supra* note 8, at 38 (quoting KARL N. LLEWELLYN, THE BRAMBLE BUSH 108 (1930)).

290. Johnson, *supra* note 8, at 328.

291. *See* Faber, *supra* note 7, at 263.

292. ROSWELL MAGILL, TAXABLE INCOME 161 n.48 (rev. ed. 1945); *see, e.g.*, Hills, *supra* note 203, at 412 (noting that, with respect to the new statutory merger requirement, "general court decisions such as those found in the *Cortland Specialty Case* ... are not controlling").

293. *See, e.g.*, Brookes, *supra* note 9, at 32; Miller, *supra* note 230, at 134; Satterlee, *supra* note 28, at 688; Comment, *supra* note 40, at 142.

294. Comment, *supra* note 40, at 142.

since been removed by subsequent Acts, the attitude was that "[t]he statute should . . . be interpreted literally, free of any carry-over from the gloss placed on a deleted portion. A statutory merger should be a reorganization because the statute says it is."[295] Soon after the statutory merger requirement was put in place, however, critics were quick to question the presumption that a statutory merger did not need to be subjected to the same judicial doctrines as a non-statutory merger reorganization.[296]

The lack of uniformity among the general merger or consolidation statutes highlighted the problems in relying upon state corporation law to perform the gatekeeping function that the courts had provided prior to 1934. James Fahey explained that "[t]hey were not drafted with the thought that their provisions would be a criteria of federal income tax liability."[297] Thus, in many cases, they were not well-suited to serving such a function.[298] In 1935, the laws of Arkansas, California, Florida, Illinois, Nevada, Ohio, and Tennessee authorized a merger or consolidation even when the transferee corporation conveyed to the transferor corporation securities other than shares of its stock as consideration.[299] Arkansas's 1931 merger statute, for example, explicitly stated that "[t]he agreement may provide for the distribution of cash, notes or bonds in whole or in part, in lieu of stock to the stockholders of the constituent corporations or any of them."[300] Other statutes permitted the distribution of "shares or other securities or obligations of the surviving corporation," thus permitting the use of bonds rather than instruments evidencing a proprietary interest in the continuing venture.[301] Furthermore, few if any state merger statutes then or today require post-reorganization continuity or restrict the ability to

295. Brookes, *supra* note 9, at 32. One observer commented that "the history and structure of the reorganization provisions prior to the Revenue Act of 1934 indicate that any requirement of a continuity of interest was consciously and advisedly omitted from the definition of reorganization in clause A." Satterlee, *supra* note 28, at 688; *see also* Miller, *supra* note 234, at 134 ("[T]he changes made when the 1934 law was enacted make it possible, under that and subsequent laws, to follow the literal meaning, without looking to such vague considerations as 'underlying assumptions and purposes.' ").

296. *See, e.g.*, Fahey, *supra* note 64, at 950; Comment, *supra* note 156, at 142.

297. Fahey, *supra* note 64, at 948.

298. *See id.*; *see also* 11 MERTENS, *supra* note 29, § 43.02, at 22-24 n.24 (discussing the limitations of state laws with respect to statutory reorganizations).

299. *See* Fahey, *supra* note 64, at 950 n.77; Comment, *supra* note 156, at 141 n.48.

300. ARK. DIG. STAT. § 1701i2 (Crawford & Moses Supp. 1931).

301. *E.g.*, ILL. REV. STAT. ch. 32, § 62 (Cahill & Moore 1935); *see also* Miller, *supra* note 230, at 200 ("[S]ome 'modern' state statutes permitted mergers without *any* equity consideration."); Comment, *supra* note 156, at 141 n.48 (discussing several states' statutes).

sell the stock received in the surviving or resulting corporation.[302] Thus, despite the statutory merger requirement's promise of bringing certainty and predictability to an area previously shrouded with ambiguity, practitioners were still left to debate whether strict compliance with the requirements of state law was both necessary and sufficient.

The resulting uncertainty produced an unusual amount of litigation and confusion involving the statutory merger requirement. As one member of the New York Bar noted, clause A regarding statutory mergers and consolidations, "which at first was rather generally thought to be the easiest provision of the new statute to apply, has, strangely enough, been provocative of more recent litigation than any other section of the reorganization statute."[303] It was not until 1944, ten years after the insertion of the statutory merger requirement, that the issue of whether the judicial doctrine of continuity of interest applied to a statutory merger or consolidation was finally resolved by the courts in *Roebling v. Commissioner*.[304] In that case, South Jersey Gas, Electric and Traction Company ("South Jersey") merged with the Public Service Electric and Gas Company ("Public Service") pursuant to the requirements of New Jersey's merger statute.[305] Under the plan of reorganization, the former stockholders of South Jersey exchanged their stock for eight percent one hundred-year first mortgage bonds of Public Service.[306] The merger agreement expressly provided that the merger would not affect the capital stock of Public Service and that the shares of stock in South Jersey would be delivered up and canceled.[307] Roebling, an individual holding 166 shares of stock in South Jersey prior to the merger, treated the transaction as a tax-free reorganization and did not recognize any of the income realized on the bonds received from Public Service.[308] In sustaining the Commissioner's assertion of a deficiency, the Third Circuit quickly disposed of the notion that

302. *See* Faber, *supra* note 7, at 263.

303. Clarence Castimore, *Effect of Recent Decisions upon Reorganization and Basis Problems*, 3 INST. ON FED. TAX'N 130, 138 (1944).

304. 143 F.2d 810 (3d Cir. 1944).

305. *See id.* at 811-12.

306. *See id.* Public Service had previously attempted to use 6% cumulative preferred stock callable in three years to merge with other companies, but such mergers had been enjoined by the Chancery Court of New Jersey on the grounds that the consideration was unfair to the minority stockholders of the merged corporations. *See id.* (citing Outwater v. Public Serv. Corp., 143 A. 729 (N.J. Ch. 1928)).

307. *See id.*

308. *See id.*

complying with state law merger statutes was sufficient to obtain nonrecognition treatment. According to the court, the fact that the merger was "a 'true statutory merger' under New Jersey law is not dispositive of the question as to whether there was a 'statutory merger' here within the meaning of Sec. 112(g)(1)(A). It is well-settled that a State law cannot alter the essential characteristics required to enable a taxpayer to obtain exemption" from federal taxation.[309]

Although several courts had by then decided that the continuity of interest doctrine did not apply to a recapitalization, or E reorganization,[310] the court distinguished such cases on the basis that a recapitalization, involving no change of assets or capital stock, was fundamentally different from a merger or consolidation.[311] Since the long-term bonds received by the former South Jersey stockholders did not constitute a proprietary interest in Public Service, the Third Circuit agreed with the Tax Court that "no continuing stake in the merged enterprise was retained by South Jersey or its stockholders."[312] Therefore, the court concluded that "we cannot subscribe to the taxpayer's contention that under Sec. 112(g)(1)(A) of the Revenue Act of 1938 the requirements of New Jersey law supersede the 'continuity of interest' test as applied in *LeTulle v. Scofield* and the numerous other decisions."[313]

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309. *Id.* at 812. The case cited by the Third Circuit for the proposition that it is "well-settled" that state law cannot affect a determination of exemption from federal tax, *Mutual Fire Insurance Co. v. United States*, 50 F. Supp. 665 (E.D. Pa. 1943), is of questionable precedent in this instance. In that case, the issue leading to the statement was whether the taxpayer qualified as a mutual company exempt from federal taxation under section 101(11) of the Revenue Act of 1938, *see id.* at 667. The particular section, and its corresponding regulation, did not define mutual company with reference to state law and the court rebuffed the taxpayer's claim that its classification as a mutual company under state law was sufficient. *See id.* at 671-74. By contrast, the statutory merger requirement specifically directs the IRS to examine whether the merger qualifies as such under state law.

310. *See* I.R.C. § 368(a)(1)(E) (West Supp. 1998); *see, e.g.*, Commissioner v. Capento Sec. Corp., 140 F.2d 382 (1st Cir. 1944) (involving an exchange of new preferred stock for an outstanding bond issue); Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942) (involving an exchange of 20-year 6% debentures for 10-year 3.25% debentures); Annis Furs, Inc. v. Commissioner, 2 T.C. 1096 (1943) (involving an issuance of debentures in exchange for outstanding preferred stock), *acq.*, 1944 C.B. 2; Docherty v. Commissioner, 47 B.T.A. 462 (1942) (same); Schoo v. Commissioner, 47 B.T.A. 459 (1942) (same).

311. *See Roebling*, 143 F.2d at 814 (citing Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942)).

312. *Id.*

313. *Id.* at 813. In *LeTulle v. Scofield*, 308 U.S. 415 (1940), the Court held that a creditor's interest as evidenced by the receipt of bonds was insufficient to satisfy the continuity of interest test. *See id.* at 420-21. Notwithstanding the fact that *LeTulle* was a

The applicability of the continuity of interest test to statutory mergers was confirmed by the Fifth Circuit in *Southwest Natural Gas Co. v. Commissioner*.[314] Pursuant to Delaware's merger statute, Peoples Gas & Fuel Corporation ("People") merged with and into Southwest Natural Gas Company ("Southwest").[315] In the exchange, People's former stockholders had the option to receive either cash only or a mixture of stock, bonds, and cash.[316] The holders of 59.2% of People's stock chose the latter option, receiving 16.4% of Southwest's stock having an aggregate market value of $5592.50, $340,350 in the principal amount of 6% mortgage bonds and $17,779.50 in cash.[317] The remainder of People's holders elected to receive an aggregate of $230,700 in cash.[318] Thus, according to the court's calculations, "less than one per cent of the consideration" was paid by Southwest in stock.[319] Agreeing with the *Roebling* court that the continuity of interest test "must be met before a statutory merger may properly be a reorganization within the terms of Section 112(g)(1)(A),"[320] the Fifth Circuit explained further that continuity of interest is not satisfied unless the corporation can show: "(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

C-type asset acquisition decided under the old parenthetical clause, *see* Brookes, *supra* note 9, at 13; Miller, *supra* note 230, at 204, and that the other two cases cited by the court in support of its holding, *Commissioner v. Gilmore's Estate*, 130 F.2d 791 (3d Cir. 1942), and *Morgan Manufacturing Co. v. Commissioner*, 124 F.2d 602 (4th Cir. 1941), were not on point, the statutory merger requirement appeared to have been rendered a dead letter as a bright line standard for nonrecognition treatment. In *Gilmore's Estate*, the court applied the business purpose requirement to a statutory merger to determine if it was a sham and concluded it was not. *See Gilmore's Estate*, 130 F.2d at 794-95. While this suggests that there is some judicial gloss to the statutory merger requirement, the court did not decide that the substantive requirements of state law would be examined to see if a merger really occurred for tax purposes. *See id.* at 792-93. In *Morgan Manufacturing*, the court used what is now known as the step-transaction doctrine to hold that a cash sale in which a statutory merger was an intermediate step was not a reorganization by virtue of the merger. *See Morgan Mfg.*, 124 F.2d at 602. This again elaborates on the role of the judiciary in interpreting the Code, but does not suggest that it may determine whether a statutory merger is really a merger.

314. 189 F.2d 332 (5th Cir. 1951).

315. *See id.* at 333.

316. *See id.* at 334-35.

317. *See id.* at 335.

318. *See id.*

319. *Id.*

320. *Id.* at 334.

transferred."[321] Since a less than 1% continuing proprietary interest did not meet this formulation of the test, the court affirmed the Tax Court's decision to sustain the Commissioner.[322]

Thus, soon after its insertion into the A reorganization clause under the Revenue Act of 1934 and its adoption as part of the Internal Revenue Code in 1939,[323] the statutory merger requirement was an anachronism. It neither produced certainty and predictability by permitting taxpayers to control their fate through compliance with state merger procedures, nor, because of the variability in state merger statutes, did it serve as an effective filter against transactions attempting to characterize sales as mergers or consolidations. The requirement only served arbitrarily to force parties in states without progressive corporation laws to resort to the less attractive option of complying with the stricter reorganization provisions—provisions that could not pretend to cover all cases with a legitimate claim to nonrecognition treatment.[324] Moreover, the addition of the statutory merger requirement to the Code only complicated Treasury's task. As one contemporary practitioner stated, "[t]he changed provision has increased rather than simplified the administrative problems of the Treasury, as each examining revenue agent must become an expert in the corporation law of his state or pass the entire problem back to Washington for solution."[325] Placed into the 1934 Act as a method of further guarding against tax avoidance, critics complained that "the result has been to hamstring the tax-free reorganization provisions to the point where they amount to little more than an empty gesture toward the encouragement of necessary business adjustments."[326]

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321. *Id.*

322. *See id.* at 335.

323. Originally, tax laws were enacted as part of a succession of federal Revenue Acts, each of which repealed its immediate predecessor. In 1939, however, the tax laws were compiled in an Internal Revenue Code. Each successive Revenue Act constituted an amendment to the relevant provisions of the Code. *See* MAGILL, *supra* note 63, at 7.

324. *See* Fahey, *supra* note 64, at 968; *see also* George v. Commissioner, 26 T.C. 396 (1956) (applying the C reorganization clause test for the consolidation of a Louisiana and Mississippi corporation that was not specifically questioned by Mississippi authorities, but could not be approved in Louisiana because its statute approved the consolidation of foreign and domestic corporations only when authorized by the laws of the foreign corporation's state of incorporation); 11 MERTENS, *supra* note 29, § 43.02, at 22 n.24 (noting that the requirement of a "statutory merger" produces inequitable results due to the wide disparity in state statutes).

325. Latham, *supra* note 200, at 41.

326. Fahey, *supra* note 64, at 968. The spread of merger statutes and the complete or partial adoption by several states of the Uniform Business Corporation Act in 1928 and the Model Business Corporation Act in 1950 lessened these concerns that the variability in

II. THE CASE FOR REMOVING THE STATUTORY MERGER REQUIREMENT

Congress should eliminate the statutory merger requirement from the reorganization provisions. While the requirement has never been a particularly useful part of the reorganization provisions, recent developments suggest that now is the time to remove it altogether. The statutory merger requirement is out of step with recent congressional efforts to reduce the Code's reliance on historic and formalistic differences among state statutes. Moreover, the statutory merger requirement's reliance on state corporation laws as a guard against tax avoidance has become both over-inclusive and under-inclusive.

A. *The Statutory Merger Requirement Is at Cross-Purposes with the New Check-the-Box Regulations*

Although the statutory merger requirement was consistent with the traditional method of classifying entities under the Code, it appears to be at odds with the recently adopted check-the-box regulations,[327] which permit entities to elect their tax classification under the Code. Not only do the check-the-box rules supplant the notion that state law distinctions are important under the Code, but they potentially open up the tax-free reorganization provisions to new tax classifications for non-traditional entities such as single-member limited liability companies. The statutory merger requirement—by elevating in importance the historical differences among state statutes and by limiting the benefits of A reorganization treatment to state-law corporations—stands in the way of this progressive development of the Code.

Under the old "corporate resemblance" test, the tax classification of entities was determined by applying a complicated set of four corporate characteristics designed to replicate the criteria

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state statutes would render the A reorganization option a tool of limited availability, but these developments were far from a complete resolution of the issue. Only four states adopted the Uniform Business Corporation Act in whole or in part, and it was withdrawn in 1943 and renamed the Model Business Corporation Act. Meanwhile, the ABA developed its own version of the Model Business Corporation Act which was published in 1950. Nine states based their corporation statutes on the ABA's version of the Act between 1950 and 1959, and 11 additional states adopted the ABA's version of the Act's provisions between 1960 and 1969. *See* Robert Hamilton, *Reflections of a Reporter*, 63 TEX. L. REV. 1455, 1455-57 (1985).

327. *See* Treas. Reg. § 301.7701-3 (1998). For a description of the check-the-box regulations, see *supra* text accompanying notes 340-46.

used by state corporation laws.[328] These four factors, enacted in response to a decision by the Ninth Circuit in United States v. Kintner,[329] were (1) limited liability (that is, an owner of interests in the entity is not liable for the entity's debts); (2) centralized management (that is, rather than managing the entity themselves, the owners appoint a group of managers similar to a corporation's board of directors); (3) free transferability of interests (that is, the interests in the entity may be transferred without securing the consent of the entity's other owners); and (4) continuity of life (that is, the entity's existence does not end automatically on the death, resignation, bankruptcy, etc., of one of its owners).[330] Under what became known as the *Kintner* test, an entity with three or more of the characteristics was classified as a corporation for federal income tax purposes.[331] This test, however, became increasingly formalistic. In 1995, the IRS issued a Notice announcing its intent to consider an alternative method of classification.[332] According to the Notice, taxpayers and the IRS continued to expend significant resources in determining the classification of entities for tax purposes despite the fact that state statutes had begun to blur the distinction: "[M]any states have recently revised their statutes to provide that partnerships and other unincorporated organizations may possess characteristics that have traditionally been associated with corporations, thereby narrowing considerably the traditional distinctions between corporations and partnerships."[333] The Notice proposed an elective system of classification.[334]

In December of 1996, such an elective system was adopted. The Treasury Department issued final regulations permitting non-state

328. *See* William B. Brannan, *Lingering Partnership Classification Issues (Just When You Thought It Was Safe to Go Back into the Water)*, 1 FLA. TAX REV. 197 (1992); Amy Eisenberg & William Galanis, *To "A" or not to "A": Can a Single Member LLC Be the Acquirer in an "A" Reorganization?*, 38 TAX MGMT. MEM. S-193 (July 21, 1997); Henry J. Lischer, Jr., *Elective Tax Classification for Qualifying Foreign and Domestic Business Entities Under the Final Check-the-Box Regulations*, 51 SMU L. REV. 99, 103-04 (1997); Victor E. Fleischer, Note, *"If It Looks Like a Duck": Corporate Resemblance and Check-the-Box Elective Tax Classification*, 96 COLUM. L. REV. 518 (1996).

329. 216 F.2d 418 (9th Cir. 1954).

330. *See id.* at 422; Armando Gomez, *Rationalizing the Taxation of Business Entities*, 49 TAX LAW. 285, 291-93 (1996). The adoption of this test was an attempt to simplify the "corporate resemblance" test enunciated in *Morrissey v. Commissioner*, 296 U.S. 344 (1935). *See* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF BUSINESS ORGANIZATIONS 426 (2d ed. 1997); Lischer, *supra* note 328, at 103-04.

331. *See* Gomez, *supra* note 331, at 292.

332. *See* I.R.S. Notice 95-14, 1995-1 C.B. 297.

333. *Id.*

334. *See id.*

law corporations to elect to be taxed as either a corporation or association, as a partnership, or to be disregarded as an entity separate from its owner in the case of certain single-owner entities.[335] In their official explanation to the new regulations, the IRS and the Treasury Department cited a desire to distance the Code from the requirements of state corporation laws: "The existing regulations for classifying business organizations as associations (which are taxable as corporations under section 7701(a)(3)) or as partnerships under section 7701(a)(2) are based on the historical differences under local law between partnerships and corporations. Treasury and the IRS believe that those rules have become increasingly formalistic."[336] Local law therefore takes on a diminished significance under this system. As one observer commented, "[t]he so-called 'check-the-box' regulations mark the toppling of the old, formalistic regime."[337] Thus, according to the preamble, "certain joint undertakings that are not entities under local law may nonetheless constitute separate entities for federal tax purposes; however, not all entities formed under local law are recognized as separate entities for federal tax purposes."[338]

Under the regulations as adopted effective January 1, 1997,[339] a non-trust entity that is not automatically classified as a corporation, or an "eligible entity," may elect its treatment under the Code.[340] Generally, a domestic eligible entity with at least two members can elect to be classified as either a corporation or a partnership,[341] while a domestic eligible entity with a single owner can elect to be classified as either a corporation or to be disregarded as an entity separate

335. *See IRS Issues Final Entity Classification Regulations*, TAX NOTES TODAY, Dec. 18, 1996, at 245-1, *available in* LEXIS, Fedtax Library, TNT File. Proposed regulations were issued on May 13, 1996, and a public hearing was held on the regulations on August 21, 1996. *See* T.D. 8697, 1997-2 I.R.B. 11.

336. I.R.S. Notice 95-14, 1995-1 C.B. 297.

337. Larry E. Ribstein & Mark A. Sargent eds., *Check-the-Box and Beyond: The Future of Limited Liability Entities*, 52 BUS. LAW. 605, 615 (1997).

338. T.D. 8697, 1997-2 I.R.B. 11.

339. *See* Treas. Reg. § 301.7701-3(f) (1998).

340. The regulations preserve the general distinction between trusts and business entities. Trusts generally do not have associates and do not carry on business for profit. *See* T.D. 8697, 1997-2 I.R.B. 11. Entities organized as corporations under federal, state, or tribal law, associations under Treasury Regulation § 301.7701-3, joint-stock companies, insurance companies, insured banking entities, business entities wholly owned by a state or political subdivision, business entities taxed as corporations under some other provision of the Code, and certain foreign entities are automatically classified as corporations under the regulations. *See* Treas. Reg. § 301.7701-2(b) (1998).

341. *See* Treas. Reg. § 301.7701-3(a).

from its owner.[342] Because of the potential for this elective regime to overwhelm the capacity of the IRS to administer the paperwork, however, the regulations also establish default rules. A domestic eligible entity that does not file an election is classified as a partnership if it has two or more members and is disregarded as an entity separate from its owner if it has a single owner.[343] A foreign eligible entity that does not file an election is classified as a partnership if it has two or more members, at least one of whom has unlimited liability, as a corporation if all members have limited liability, and is disregarded as an entity separate from its owner if it has a single owner and that owner has unlimited liability.[344] For purposes of determining limited liability, the check-the-box regulations continue to rely on the statute or law pursuant to which the entity is organized.[345]

One of the most written about changes ushered in by the new check-the-box regime is the codification of a "tax nothing" status for certain single owner entities such as limited liability companies ("LLCs").[346] While it appeared that a single member entity lacking two of the four corporate characteristics should have been disregarded for federal income tax purposes under prior law,[347] the check-the-box regulations officially confirmed this conclusion and paved the way for a number of creative tax planning devices and transactions. One such transaction is an A reorganization in which a

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342. *See id.*

343. *See id.* § 301.7701-3(b)(1).

344. *See id.* § 301.7701-3(b)(2).

345. *See id.* § 301.7701-3(b)(2)(ii).

346. *See* Michael L. Schler, *Initial Thoughts on the Proposed "Check-the-Box" Regulations*, 71 TAX NOTES 1679, 1682 (1996) (coining the phrase "tax nothing" to describe the single-member LLC under the new check-the-box regulations); *see also* Lawrence M. Axelrod, *Are Consolidated Returns Obsolete?*, 74 TAX NOTES 89, 89-90 (1997) (referring to a single-member LLC as a "tax nothing"); Christopher Barton, *Much Ado About a Nothing: The Taxation of Disregarded Entities*, TAX NOTES TODAY, June 30, 1997, at 125-98, *available in* LEXIS, Fedtax Library, TNT File (same); Eisenberg & Galanis, *supra* note 328, at S-193 (same); David S. Miller, *The Tax Nothing*, 74 TAX NOTES 619, 620 (1997) (same).

347. *See* Priv. Ltr. Rul. 87-37-100 (June 19, 1987); Priv. Ltr. Rul. 85-33-003 (May 7, 1985); Gen. Couns. Mem. 39,395 (Aug. 5, 1985); Joel Rabinovitz & Eric M. Zolt, *Tax Nothings*, 75 TAXES 869, 869 (1997); Francis J. Wirtz & Kenneth L. Harris, *Tax Classification of the One-Member Limited Liability Company*, 59 TAX NOTES 1829, 1833 (1993); Bernard Wolfman, *How to Treat Single-Member LLCs*, 68 TAX NOTES 361, 361 (1995). *But see* Rod Garcia, *Single-Member LLCs: Basic Entities Raise Complex Problems*, 68 TAX NOTES 142, 142-43 (1996) (suggesting classification as a corporation); Pomy Ketema, Note, *Did the Federal Check-the-Box Regulations Open up a State Tax Pandora's Box? A Reflection on State Conformity to the New Federal Classification Scheme of Single-Member LLCs*, 82 MINN. L. REV. 1659, 1660 (1998) (same).

target corporation merges into the acquirer's single-member limited liability company in exchange for stock of the acquirer. Public companies often resist conducting an acquisition through an A reorganization, despite its less restrictive requirements, because of the state-law liability concerns involved with absorbing another corporation, the shareholder approval requirements imposed for mergers directly into the parent company, and the prohibition on regulated companies from conducting certain businesses directly.[348] However, by setting up an LLC of which the acquiring company is the only member, the target corporation can merge into the acquirer's LLC for state law purposes while being treated as if it merged into the parent corporation under § 368(a)(1)(A) for federal income tax purposes.[349]

To date, the IRS has not officially confirmed that a single member LLC A reorganization is permissible under the Code.[350] The question surrounding the applicability of nonrecognition treatment under § 368(a)(1)(A) is whether the merger recognized by state law needs to be the same merger deemed to occur for federal income tax purposes. Most commentators, however, have concluded through an analysis of similar IRS rulings and the policies that underlie them that a single member LLC merger with a corporation can qualify for nonrecognition as an A reorganization.[351] In the analogous area of

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348. *See* 1 GINSBURG & LEVIN, *supra* note 7, § 801.6; Irving Evall et al., *Tax and Practical Considerations in the Negotiation for the Purchase/Sale of a Going Business: A Panel Discussion*, 30 INST. ON FED. TAX'N 893, 916 (1972). Another concern is the shareholder approval requirement for direct mergers that may not be applicable in the context of a triangular merger or other form of reorganization. *See* Lynch, *supra* note 4, at 742.

349. A single-member LLC A reorganization would probably need to be designed as a merger of the target into the acquirer's LLC, rather than as an acquisition of a corporation's single-member LLC, to qualify for nonrecognition treatment. Although a merger of a single-member LLC into a corporation would qualify as a merger for state law, the transaction would risk recharacterization as a failed C reorganization if the LLC constituted less than substantially all of the target's assets. Additionally, it might run afoul of the requirements for a valid spin-off under § 355. *See* Rabinovitz & Zolt, *supra* note 348, at 874.

350. The IRS appears to be struggling with the choice of permitting single-member LLC mergers to qualify as A reorganizations or forcing them to satisfy the requirements for a stock-for-assets C reorganization. According to one reporter, "a decision is expected soon." Lee A. Sheppard, *More Mischief with Tax Nothings*, 80 TAX NOTES 762, 764 (1998).

351. *See, e.g.*, 1 GINSBURG & LEVIN, *supra* note 7, § 801.6; Eisenberg & Galanis, *supra* note 328, at S-197; Rabinovitz & Zolt, *supra* note 348, at 873. *But see* Axelrod, *supra* note 347, at 91 (concluding that an LLC could not be a party to a reorganization under I.R.C. § 368(b)); Jeffrey A. Maine, *Evaluating Subchapter S in a "Check-the-Box" World*, 51 TAX LAW. 717, 745-46 (1998) (same).

qualified Real Estate Investment Trusts ("REIT") subsidiaries,[352] business forms that are also disregarded from their owners for tax purposes, the IRS has ruled that the merger of a target corporation into a qualified REIT subsidiary in exchange for the stock of the REIT parent can qualify as an A reorganization rather than a triangular merger in which the stock of the parent is utilized or as a stock for assets exchange under § 368(a)(1)(C).[353] A 1958 Revenue Ruling reached a similar conclusion. Under the situation described in that Ruling, X, a corporation, owned 79% of the stock of Y, a corporation incorporated in State C. Individuals owned the remaining 21% of the stock. To eliminate the minority shareholders and to continue Y's activities in State B, Y engaged in a reincorporation statutory merger with a newly formed State B corporation, Z, in which Y transferred all of its assets to Z in exchange for all of the Z stock. Y then merged into its parent, X, with the result that X now conducted its subsidiary business in State B through a wholly rather than partially owned subsidiary. Although Z merged with Y rather than X under state law, the IRS recharacterized the transaction as a merger between Z and X and permitted the transaction to qualify as an A reorganization followed by a drop-down of assets to a wholly owned subsidiary under § 368(a)(2)(C).[354] Thus, in both contexts, the IRS treated a transaction as an A reorganization even though it resulted from a state-law merger that was different than the one deemed to occur for federal income tax purposes.[355] Furthermore, the same result should

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352. A REIT is an entity that invests primarily in passive real estate investments and is permitted to pass-through its income without tax to the holders of its interests. In this sense, it is generally taxed like a partnership on distributed earnings. *See* 11 MERTENS, *supra* note 29, § 41A.01, at 3. A Qualified REIT Subsidiary is a wholly owned corporation that is treated as a division of the REIT for federal income tax purposes. *See* I.R.C. § 856(i) (West Supp. 1998).

353. *See* Priv. Ltr. Rul. 95-12-020 (Dec. 29, 1994); Priv. Ltr. Rul. 89-03-074 (Oct. 26, 1988).

354. *See* Rev. Rul. 58-93, 1958-1 C.B. 188.

355. A recent private letter ruling reconfirms the IRS's willingness to treat a transaction as a statutory merger even if the merged corporation did not directly merge into the surviving entity under state law. *See* Priv. Ltr. Rul. 97-43-010 (June 22, 1997) (concerning a two-step transaction involving an acquisition merger and an upstream merger "treated as if Acquiring directly acquired the Target assets in exchange for Acquiring stock and Acquiring's assumption of Target liabilities through a 'statutory merger' as that term is used in § 368(a)(1)(A)" (citations omitted)). There is a contrary line of authority in the context of a merger that a corporate "grandparent" causes to be directed. *See* Eisenberg & Gallanis, *supra* note 328, at S-196 to S-197. A merger of the target corporation into a second-tier subsidiary of the parent corporation in exchange for the parent's stock would not qualify for A reorganization treatment. Instead, the parent agrees to acquire the target's assets in exchange for its stock, but directs the target to

be reached in the context of limited liability entities such as the recently created Qualified Subchapter S Subsidiary that can similarly be disregarded as an entity separate from its owner.[356] As Joel Rabinovitz and Eric Zolt have observed, "there does not appear to be any tax policy requiring liability exposure as a prerequisite for tax deferral and, therefore, no policy objection to treating direct mergers into tax nothings as mergers into the parent subject only to the requirements of an A reorganization."[357]

Despite the theoretical possibilities opened up for the LLC A reorganization by the check-the-box regulations and the rule's stated goal to reduce the tax code's reliance on the arbitrary and formalistic differences among state corporate laws, the statutory merger requirement poses an insurmountable obstacle in many states. The LLC vehicle is itself of recent vintage. Originating in Wyoming in 1977,[358] the LLC became available in all fifty states and the District of Columbia only in the past few years.[359] This relatively slow development of state law is likely to be repeated in the adoption of provisions permitting LLCs to merge with corporations. In some states, an LLC is still required to have more than one member, and in the forty-three states that permit a single-member LLC, only twenty-nine authorize such LLCs to merge with corporations.[360] While

transfer its assets directly to the second-tier subsidiary. The IRS has recast this transaction as a C reorganization followed by a drop-down even when the transfer to the second-tier subsidiary occurs by virtue of a statutory merger. *See, e.g.*, Rev. Rul. 70-224, 1970-1 C.B. 79; Priv. Ltr. Rul. 96-17-051 (Jan. 30, 1996). Although the IRS has never stated that the transactions could not be treated as A reorganizations, some commentators have arrived at this negative inference. *See, e.g.*, Eisenberg & Gallanis, *supra* note 328, at S-196 to S-197.

356. *See* I.R.C. § 1361(b)(3) (West Supp. 1998) (adopted by the Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1308(b), 110 Stat. 1755, 1782).

357. Rabinovitz & Zolt, *supra* note 347, at 873. In a similar example, the IRS has ruled that an exchanging party's use of a single-member LLC in a like-kind exchange under § 1031 does not violate the requirement that the property be "held." *See* Priv. Ltr. Rul. 98-07-013 (Nov. 13, 1997); Priv. Ltr. Rul. 97-51-012 (Sept. 15, 1997); *see also* Michael G. Schinner, *IRS Rulings Expand Opportunities for Using Single-Member LLCs in 1031 Exchanges*, 88 J. TAX'N 286 (1998) (discussing the benefits of using single-member LLCs to hold real property).

358. *See* William J. Carney, *Limited Liability Companies: Origins and Antecedents*, 66 U. COLO. L. REV. 855, 855 (1995); Ribstein & Sargent, *supra* note 338, at 615 (quoting John DeBruyn).

359. *See* Axelrod, *supra* note 346, at 89; Lischer, *supra* note 328, at 102. Most states adopted LLC statutes between 1990 and 1996—after the IRS confirmed their favorable tax treatment in 1988. *See* Ketema, *supra* note 347, at 1667.

360. The following states permit single-member LLCs: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Delaware, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, New York, North

important incorporation jurisdictions such as Delaware, New York, and Texas are among the states to permit single-member LLC mergers, equally important jurisdictions such as California, Massachusetts, and Nevada do not permit single-member LLCs.[361] In

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Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Texas, Utah, Vermont, Virginia, Washington, West Virginia, and Wisconsin. *See* ALA. CODE § 10-12-9 (Supp. 1998); ALASKA STAT. § 10.50.155(b) (Michie Supp. 1998); ARIZ. REV. STAT. ANN. § 29-631 (West 1998); ARK. CODE. ANN. § 4-32-201 (Michie 1996); COLO. REV. STAT. § 7-80-203 (1998); CONN. GEN. STAT. ANN. § 34-101(9) (West 1997); DEL. CODE ANN. tit. 6, § 18-101(6) (Michie Supp. 1998); FLA. STAT. § 608.405 (Supp. 1999); GA. CODE ANN. § 14-11-100(12) (Supp. 1998); HAW. REV. STAT. ANN. § 428-202 (Michie Supp. 1997); IDAHO CODE § 53-607 (1994); ILL. COMP. STAT. ANN. 180/5-1(b) (West Supp. 1998); IND. CODE ANN. § 23-18-2-4 (1995); IOWA CODE ANN. § 490A.102(13) (West Supp. 1998); KAN. STAT. ANN. § 17-7605 (Supp. 1998); KY. REV. STAT. ANN. § 275.020 (Michie Supp. 1996); LA. REV. STAT. ANN. § 12:1301(A)(10) (West Supp. 1999); ME. REV. STAT. ANN. tit. 31, § 621 (West Supp. 1998); MD. CODE ANN., CORPS. & ASS'NS § 4A-202 (Supp. 1998); MICH. STAT. ANN. § 21.198(4202) (Law Co-op Supp. 1998); MINN. STAT. ANN. § 322B.11 (West Supp. 1999); MISS. CODE ANN. § 79-29-103(h) (Supp., 1998); MO. REV. STAT. § 347.017 (Supp. 1999); MONT. REV. CODE ANN. § 35-8-201 (Smith 1997); NEB. REV. STAT. § 21-2605 (1997); 1998 N.J. Sess. Law Serv. 79, § 2 (West) (to be codified at N.J. STAT. ANN. § 42:2B-2); N.M. STAT. ANN. § 53-19-7 (Michie 1993); N.Y. LTD. LIAB. CO. LAW § 102(m) (McKinney 1999); N.C. GEN. STAT. § 57C-2-20 (Michie 1997); N.D. CENT. CODE § 10-32-06 (Supp. 1997) (permitting single-member LLCs if they are authorized in the Articles of Organization); OHIO REV. CODE ANN. § 1705.04 (Anderson Supp. 1997); OKLA. STAT. ANN. tit. 18, § 2001(11) (West 1999); OR. REV. STAT. § 63.044 (1997); 15 PA. CONS. STAT. ANN. § 8912 (West 1995); R.I. GEN. LAWS § 7-16-5 (Lexis Supp. 1998); S.D. CODIFIED LAWS § 47-34A-202.1 (Michie Supp. 1998); TEX. REV. CIV. STAT. ANN. art. 1528n, art. 4.01 (West 1997); UTAH CODE ANN. § 48-2b-103 (Supp. 1998); VT. STAT. ANN. tit. 11, § 3022 (1997); VA. CODE ANN. § 13.1-1046.3 (Michie Supp. 1998) (although not specifically authorizing the formation of a single-member LLC, the statute provides that no dissolution shall occur as long as the LLC has at least one member); WASH. REV. CODE ANN. § 25.15.070 (West Supp. 1999); W. VA. CODE § 31B-2-202 (1996); WIS. STAT. ANN. § 183.0201(West Supp. 1998). Of these states permitting single-member LLCs, the following states do not authorize LLCs to merge with corporations: Alaska, Colorado, Connecticut, Hawaii, Indiana, Kansas, Michigan, Mississippi, Montana, New Mexico, North Carolina, Oregon, Utah, and Wisconsin. *See* ALASKA STAT. § 10.50.500 (Michie Supp. 1998); COLO. REV. STAT. § 7-80-1003 (1998); CONN. GEN. STAT. ANN. § 34-193 (West 1997); HAW. REV. STAT. ANN. § 428-904 (Michie Supp. 1997) (permitting corporations to merge into LLCs but not appearing to authorize the reverse); IND. CODE ANN. § 23-18-7-1 (1995); KANS. STAT. ANN. § 17-7650 (1995) (permitting corporations to merge into LLCs but not appearing to authorize the reverse); MICH. STAT. ANN. § 21.198(4701) (Law Co-op Supp. 1998); MISS. CODE ANN. § 79-29-209 (Supp. 1998) (unless otherwise provided in the certificate of formation or limited liability company agreement); MONT. REV. CODE ANN. § 35-8-1201 (Smith 1997); N.M. STAT. ANN. § 53-19-59 (Michie 1993) (unless otherwise provided by the articles of organization or an operating agreement); N.C. GEN. STAT. § 57C-9-01 (Michie 1997); OR. REV. STAT. § 63.481 (1997); UTAH CODE ANN. § 48-2b-149 (1998); WIS. STAT. ANN. § 183.1201(2) (West Supp. 1998) (unless otherwise provided in an operating agreement).

361. *See* CAL. CORP. CODE § 17050(b) (West Supp. 1999); MASS. GEN. LAWS ANN. ch. 156C, § 2(5) (West 1996); NEV. REV. STAT. ANN. § 86.151(1) (Michie Supp. 1997). Other states that do not permit single-member LLCs include New Hampshire, Tennessee, and

the fourteen states that permit single-member LLCs, but not their merger with corporations,[362] parties can effect the equivalent of a merger—the target corporation's sale of all of its assets and liabilities to the parent's single-member LLC in exchange for parent corporation stock, followed by the target corporation's liquidation—but such a transaction would be treated as a C rather than an A reorganization under the Code. If the target corporation had recently sold off a division or a large part of its assets or engaged in a redemption or spin-off, the transaction may fail the "substantially all of the properties"[363] rule for C reorganizations.[364] Similarly, if the parent corporation desired to issue stock other than voting stock, and such "boot" plus liabilities assumed exceeds 20% of the target's total assets, or if the parent corporation already holds "old and cold" some portion of the target corporation's stock,[365] the transaction may fail the "solely" for voting stock rule for C reorganizations.[366] Moreover, even if a state both recognizes a single member LLC and permits it to merge with a corporation, it is questionable whether the transaction will qualify as an A reorganization if the authority for the merger is granted under the state's LLC statute rather than its corporation laws.[367] Thus, simply by virtue of the location of the transaction, the

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Wyoming. *See* N.H. REV. STAT. ANN. § 304-C:1(V) (Supp. 1998); TENN. CODE ANN. § 48-203-103 (1995); WYO. STAT. ANN. § 17-15-106 (Michie 1997). South Carolina does not currently permit single-member LLCs or permit LLCs to merge with corporations, but has repealed those provisions effective January 1, 2001, when it adopts the Uniform Limited Liability Company Act. *See* S.C. CODE ANN. §§ 33-43-201 & 33-43-1301 (Law Co-op Supp. 1998) (repealed effective January 1, 2001).

362. *See supra* note 360.

363. I.R.C. § 368(a)(1)(C) (West Supp. 1998).

364. *See* Helvering v. Elkhorn Coal Co., 95 F.2d 732 (4th Cir. 1938); Rev. Proc. 86-42, 1986-2 C.B. 722, § 7.05(3) (requiring, for ruling purposes, that acquiring entity acquires at least 90% of the fair market value of the net assets and at least 70% of the fair market value of the gross assets held by target immediately prior to the transaction (including all redemptions and distributions made by target immediately preceding the transaction as assets held immediately prior to the transaction)); 1 GINSBURG & LEVIN, *supra* note 7, § 702.3; Rabinovitz & Zolt, *supra* note 345, at 873.

365. Whether a corporation's ownership of a target corporation's stock is sufficiently pre-existing to be considered "old and cold" depends in part on the holding corporation's subjective intent and in part on the amount of time in which the stock has been held. *See* 1 GINSBURG & LEVIN, *supra* note 7, § 701.4. The IRS takes the position that a 12-month holding period is not sufficient to establish the stock ownership as old and cold. *See* Treas. Reg. § 1.368-2(c) (1998); 1 GINSBURG & LEVIN, *supra* note 7, § 701.4.

366. *See* I.R.C. § 368(a)(1)(C); 1 GINSBURG & LEVIN, *supra* note 7, § 702.3.

367. *See* Treas. Reg. § 1.368-2(b)(1) (as amended in 1986); Rabinovitz & Zolt, *supra* note 347, at 873. In Florida, for instance, a single-member LLC merger with another business entity is authorized under the chapter of the Florida Statutes titled "Limited Liability Companies," rather than the chapter titled "Corporations." *See* FLA. STAT. ANN. §§ 607.120-.193 & 608.401-.514 (West Supp. 1999).

statutory merger requirement may convert a tax-deferred reorganization under the new check-the-box regulations into a fully taxable transaction. As in 1934 when the statutory merger requirement was inserted into the Code's reorganization provisions, the taxability of a transaction thus depends upon the progressivity and flexibility of the corporation laws in the state in which the transaction took place, rather than upon the conformity of a proposed transaction with the federal tax policies underlying nonrecognition treatment.[368]

B. *State Corporation Laws Have Become Increasingly Poor Gatekeepers*

A statutory merger requirement might still be justified, despite its inconsistency with the new check-the-box regulations and the concomitant de-emphasis on state corporate law, if it either acted as a safeguard against tax avoidance or provided a bright-line test for qualifying for nonrecognition under the Code. After all, just as a taxpayer is required to pay no more tax than is due,[369] the IRS is under no compulsion to err on the side of collecting less tax than is due under existing law. Because of the application of judicial doctrines such as continuity of interest to the statutory merger requirement, however, the requirement has long since failed as a bright-line standard. Moreover, the development of state laws indicates that the statutory merger requirement is also not a reliable safeguard against abuse. In fact, the requirement is both over-inclusive and under-inclusive as a check against tax avoidance.

1. Generally

While state merger or consolidation statutes never have been considered truly adequate for ensuring that such transactions conform to the ideals of the Code's drafters, there are indications that state corporation laws are becoming increasingly counterproductive for the task. As an initial matter, state

368. *See supra* notes 275-79 (discussing the inclusion of the statutory merger requirement in the 1934 Revenue Act).

369. As Judge Learned Hand noted: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Gregory v. Helvering, 69 F.2d 809, 810 (2d Cir. 1934), *aff'd*, 293 U.S. 465 (1935). Affirming the Second Circuit, the Supreme Court also agreed that "[t]he legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted." Gregory v. Helvering, 293 U.S. 465, 469 (1935).

corporation laws are becoming less rather than more uniform. Despite the dominant position of the Model Business Corporation Act in smaller states in the 1950s and 1960s, larger or more corporate law-oriented states have adopted their own acts. When Delaware revised its corporation act in 1967, it decided not to follow the Model Act because, in the words of the President of the United States Corporation Company, " 'we do not want to be a "me too" state.' "[370] Whether this recurrence of a so-called "race to the bottom" really has resulted in statutes favoring managers at the expense of shareholders is irrelevant to the fact that state corporation laws are diverging rather than coming together and are developing in such a way that the state in which a merger is effected has once again become important for tax purposes.[371]

Moreover, strict anti-takeover statutes in many states may thwart "desirable business adjustments," to use the language of 1921,[372] that would otherwise comply with the requirements and spirit of the reorganization provisions. In the 1980s, many states adopted anti-takeover statutes intended to deny merger treatment for transactions that would be permitted in other states. In statutes adopted in New York in 1986, New Jersey in 1987, and in Delaware in 1988, for example, an acquirer in a tender offer was prohibited from entering into a merger with the target for a period of between three and five years after the original acquisition of shares.[373] Thus, such statutes impose an elevated requirement of continuity of interest among a target's historic shareholders, excluding an acquirer from such class until several years after the acquisition. Under Wisconsin's merger statute, no target can enter into a merger with a 10% stockholder for a period of three years after such holder acquired its shares unless otherwise approved by the board of directors prior to the original acquisition.[374] Furthermore, fifteen

370. Comment, *Law for Sale: A Study of the Delaware Corporation Law of 1967*, 117 U. PA. L. REV. 861, 866-67 (1969) (quoting Minutes of the Delaware Corporation Law Revision Commission, 4th Meeting, July 14, 1964, at 2-3).

371. The original "race to the bottom" began in 1896 when New Jersey enacted the most liberal corporation law statute to date. *See* Davis, *supra* note 221, at 617.

372. *Hearings on H.R. 8245*, *supra* note 81, at 29 (statement of Dr. T.S. Adams, advisor to the Treasury Department).

373. *See* DEL. CODE ANN. tit. 8, § 203 (1991 & Supp. 1998) (three years); N.J. STAT. ANN. § 14A:10A (West Supp. 1998) (five years); N.Y. BUS. CORP. LAW § 912 (McKinney 1986 & Supp. 1999) (five years); *see also* E. Norman Veasey et al., *The Delaware Takeover Law: Some Issues, Strategies and Comparisons*, 43 BUS. LAW. 865, 866 (1988) (describing the New York and New Jersey statutes and discussing in detail Delaware takeover provisions).

374. *See* WIS. STAT. ANN. § 180.1140(8)(a) (West 1992 & Supp. 1998) (defining a

states adopted anti-takeover provisions patterned after Maryland's "fair price" and "super-majority voting" requirements for mergers of targets with their tender offer acquirers.[375] In all such cases, policy concerns which may or may not be considered relevant to nonrecognition treatment assume elevated significance for parties seeking to qualify their transaction as an A reorganization under the Code. The focus in determining tax treatment shifts from the nature of the transaction to the location of the transaction and in some cases the relationship of the parties.

2. Over-Inclusive—The Texas Example

Perhaps the most surprising and unnerving development in state corporation law for purposes of the statutory merger requirement is the expansion of the definition of merger or consolidation to cover transactions that are arguably outside the contemplation of the Code's reorganization provisions. In 1989, Texas adopted a revised Texas Business Corporation Act ("TBCA") that revolutionized the definitions of "merger" and "consolidation" in Texas.[376] Under the provisions, which are still in effect today,[377] two or more entities (regardless of whether all or some are entities other than corporations) can effect a statutory merger or consolidation in which all entities survive. Moreover, under the statute one entity may divide into two, or effect a transaction popularly referred to as a spin-off, split-off, or split-up, as a simple statutory merger rather than as a two- or three-step transaction involving conveyances, share issuances, and distributions. As currently drafted, Article 1.02 of the TBCA defines "merger" to mean:

> (a) the division of a domestic corporation into two or more new domestic corporations or into a surviving corporation and one or more new domestic or foreign corporations or other entities, or (b) the combination of one or more domestic corporations with one or more domestic or foreign corporations or other entities resulting in (i) one or more surviving domestic or foreign corporations or other

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holder of 10% of the voting stock of a corporation as an "interested stockholder"); *id.* § 180.1141 (West 1992) (imposing a three-year restriction on business combinations involving interested stockholders); ROBERT W. HAMILTON, CORPORATIONS, INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS: CASES AND MATERIALS 898 (4th ed. 1990).

375. *See* MD. CODE ANN., CORPS. & ASS'NS § 3-601 to 3-603 (1993 & Supp. 1998); HAMILTON, *supra* note 375, at 899.

376. *See* TEX. BUS. CORP. ACT ANN. arts. 1.02A(18), 5.01 (West Supp. 1999).

377. *See id.*

entities, (ii) the creation of one or more new domestic or foreign corporations or other entities, or (iii) one or more surviving domestic or foreign corporations or other entities and the creation of one or more new domestic or foreign corporations or other entities.[378]

Article 5.01 of the TBCA, which sets forth the procedure for effecting a statutory merger, also provides that "one or more domestic corporations may merge with one or more domestic or foreign corporations or other entities"[379] by adopting a plan of merger that specifies whether "more than one domestic or foreign corporation or other entity is to survive or to be created by the terms of the plan of merger."[380] If more than one entity will survive the merger, the parties are directed to describe the manner and basis of allocating the parties' assets and liabilities among the surviving entities,[381] including specifying which entity is responsible for paying dissenting shareholders.[382] To be instituted, the plan of merger must be approved by at least two-thirds of the eligible shareholders present in person or by proxy at the meeting upon which the matter is raised.[383] The result of the Texas statutory merger provision is that two entities can merge together with both surviving and a single entity can effect a merger by dividing—neither transaction being in the least bit consistent with the original conception of a merger which involved the "blending of one corporation into another, whereby the latter swallows up the properties and franchises of the first."[384]

According to Curtis Huff, one of the drafters of the Texas merger statute, the goal was to maintain "modern incorporation statutes in the State of Texas in order to attract and maintain the incorporation of corporations in the State."[385] The Commentary to the TBCA provided by the Business Law Section of the State Bar of Texas states that the new provisions were designed "to significantly expand the flexibility of corporations to engage in merger and

378. *Id.* art. 1.02A(18). Texas's definition of "merger" includes within it the ability to carry out a consolidation. *See* J. Leon Lebowitz, *The 1989 Amendments to the Texas Business Corporation Statutes: Part I*, 8 CORP. COUNS. REV. 24, 26 (1989).

379. TEX. BUS. CORP. ACT ANN. art. 5.01A.

380. *Id.* art. 5.01B(2).

381. *See id.* art. 5.01B(2)(c).

382. *See id.* art. 5.01D.

383. *See id.* art. 5.03E.

384. PAUL, *supra* note 91, at 7 n.11.

385. Curtis W. Huff, *The New Texas Business Corporation Act Merger Provisions*, 21 ST. MARY'S L.J. 109, 110 n.2 (1989). Mr. Huff was a member of the subcommittee of the Corporation Law Committee of the Business Law Section of the State Bar of Texas that drafted the amendments to the merger provisions of the TBCA. *See id.*

acquisition transactions."[386] Citing a 1985 article in the *Texas Law Review* in which the author suggested that transactions that can be accomplished through alternative structures should not be subject to the "[m]eaningless restrictions" contained in statutes such as the Revised Model Business Corporation Act,[387] the drafters pointed to several transactions that previously had to be performed through cumbersome multi-step transactions involving common law conveyancing and share issuances and distributions. Examples included "acquisitions of a single corporation by multiple corporations each desiring different segments of the acquired corporation, mergers conditioned on the sale or spin-off of unwanted assets or business segments of the acquired corporation, recapitalizations, leveraged buyouts, spin-offs, and creations of holding companies."[388] Under the corporation laws of most states, for instance, when the parties to a merger want to place some or all of the assets or liabilities of the merged corporation into another entity that is not a subsidiary of the surviving parent, but is instead separately owned by the parent's shareholders, the parties have to transfer the assets and liabilities to a subsidiary beforehand and then distribute interests in that subsidiary to the shareholders of the constituent parties under the plan of merger.[389] The new Texas merger provisions permit this transaction to be done in one step as part of the merger. The Texas statute is unprecedented and to this point has not attracted imitators; therefore, it is effectively limited to transactions among Texas corporations and other business entities.[390] Nevertheless, its existence and the possibility that it will be adopted

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386. TEX. BUS. CORP. ACT ANN. art. 5.01 commentary 121 (West Supp. 1999) [hereinafter Texas Bar Commentary].

387. J. Patrick Garrett, *Merger Meets the Common Law*, 63 TEX. L. REV. 1509, 1519 (1985); *see also* Huff, *supra* note 385, at 111 n.5 ("The new Texas merger provisions embrace Mr. Garrett's proposal that the corporation statutes should provide greater flexibility and not impose meaningless restrictions on transactions that may be accomplished through other forms and provide a framework for the future evolution of the TBCA.").

388. Huff, *supra* note 385, at 116.

389. *See* Lebowitz, *supra* note 378, at 28-29.

390. *See* Texas Bar Commentary, *supra* note 386, at 121; Huff, *supra* note 385, at 114. There is no bar, however, on the reincorporation or reorganization of one or more entities into Texas in order to effect a statutory merger under Texas law. Huff predicts rather optimistically that the "1989 amendments to the merger provisions of the TBCA represent the first of a new generation of state laws governing mergers." Huff, *supra* note 385, at 157.

Pennsylvania has adopted a statutory division provision for effecting a spin-off, but does not provide a mechanism for combining a division with a merger. *See* 15 PA. CONS. STAT. ANN. § 1951 (West 1995); Huff, *supra* note 385, at 114.

by other jurisdictions in the future illustrates the great potential for abuse of the statutory merger requirement under § 368(a)(1)(A).

One statutory merger in Texas that would otherwise be subject to stricter requirements under the Code is a spin-off. In a typical spin-off, a corporation with two different lines of business will drop the assets and liabilities of one of those businesses into a wholly owned subsidiary created for the transaction, and the parent corporation will distribute the stock of the new subsidiary to its shareholders.[391] Section 355 of the Code outlines the procedure for obtaining nonrecognition treatment for the shareholders of a corporation who receive stock or securities of a controlled corporation in a distribution by the corporation.[392] To qualify for nonrecognition under § 355, certain requirements must be met, including: (1) the transaction must not be used principally as a device for the distribution of earnings and profits;[393] (2) the distributing and controlled corporations must have engaged in the active conduct of a trade or business throughout the five years preceding the spin-off;[394] (3) the distributing corporation must distribute at least 80% of the stock of the controlled corporation in the transaction and its retention of the remaining 20% must not have as one of its principal purposes the avoidance of federal income tax;[395] and (4) the transaction must meet the § 355 business purpose requirement, which is stricter than the requirement imposed on § 368 reorganizations.[396] Thus, if, for instance, the spun-off line of business was recently started or was acquired within the five-year period preceding the date of the distribution, the transaction will not qualify for nonrecognition under § 355.[397] In Texas, however, since a spin-off can qualify as a statutory merger, a corporation desiring to spin-off its recently acquired assets could attempt to qualify as a tax-free reorganization under § 368(a)(1)(A) instead.

The IRS might challenge such an attempt on the ground that it fails to satisfy the continuity of interest requirement for A reorganizations. Shareholders of entities party to a split-off or split-

391. In a spin-off, the controlled corporation stock is distributed with respect to the stockholder's shareholdings in the parent corporation. *See supra* note 142 (explaining a spin-off). In a split-off, the controlled corporation stock is exchanged for the stockholder's stock in the parent corporation. *See supra* note 142 (explaining a split-off).

392. *See* I.R.C. § 355 (West Supp. 1998).

393. *See id.* § 355(a)(1)(B).

394. *See id.* §§ 355(a)(1)(C) & (b).

395. *See id.* § 355(a)(1)(D).

396. *See* Treas. Reg. § 1.355-2(b) (1998); 1 GINSBURG & LEVIN, *supra* note 7, § 1005.

397. *See* I.R.C. §§ 355(b)(2)(B) & (C).

up do not retain their proprietary interests in both business enterprises, and shareholders of entities party to a spin-off may not possess the requisite historic continuity of interest with respect to businesses acquired within the five-year period preceding the distribution.[398] Until recently, the IRS and the courts had broadened the focus of the continuity of interest test beyond the original concern for the type of consideration issued in the exchange to address the concepts of pre- and post-reorganization continuity.[399] Pre-reorganization continuity was instituted in the form of a requirement that only a target corporation's "historic" shareholders, or "those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization" must be the shareholders for whom continuity of interest is measured.[400] The IRS developed post-reorganization continuity to require target shareholders to hold their acquired shares for a requisite period of time.[401]

Both pre- and post-reorganization continuity requirements, however, have come under judicial and administrative attack of late. The first sign of weakening came in the Tax Court decision *J.E. Seagram Corp. v. Commissioner*.[402] This case involved a battle between Seagram and DuPont for control of Conoco. In a tender offer, Seagram acquired 32% of Conoco's stock. DuPont, however, acquired control of Conoco through its own tender offer in which 54% of the Conoco stock, including the 32% previously acquired by Seagram, was exchanged for cash and DuPont stock, after which DuPont merged Conoco into a wholly-owned subsidiary.[403] Because the stock acquired from Seagram was not from a "historic" shareholder under pre-reorganization continuity principles, Seagram claimed a loss on the sale based on the argument that 22% continuity

398. The IRS has not heretofore asserted this latter argument, but it is a logical extension of the pre-reorganization continuity requirement. If the IRS were looking for a back-door avenue for imposing the § 355 five-year active trade or business requirement in A reorganizations, this might be the most likely choice.

399. *See* Committee on Taxation of Corporations of the Association of the Bar of the City of New York, *Postreorganization Transactions and Continuity of Shareholder Interest*, 72 TAX NOTES 1401, 1402 (1996).

400. Treas. Reg. § 1.368-1(b) (1998).

401. *See id.*; Rev. Rul. 66-23, 1966-1 C.B. 67 (finding that a target shareholder under a court order in an antitrust case to dispose of the stock received in the merger within seven years did not violate continuity of interest because seven years was sufficient to establish unrestricted rights of ownership and there were no plans or arrangements in place prior to the merger for a sale of the acquirer's stock).

402. 104 T.C. 75 (1995).

403. *See id.* at 89-90.

was insufficient.[404] The Tax Court rejected Seagram's argument, holding that, absent some evidence that Seagram and DuPont acted in concert, it stepped into the shoes of its former stockholders and continuity of interest was thus satisfied.[405]

The continuity of interest requirement was further called into question when the IRS issued proposed regulations that substantially narrowed the post-reorganization continuity of interest requirement.[406] Under the proposed regulations, which have since been adopted in final form, dispositions of stock of the acquiring corporation by former target shareholders after the reorganization will not be taken into account for continuity of interest purposes unless such dispositions are made to the acquiring corporation or a related entity.[407] The final regulations extend this narrowing of the post-reorganization continuity of interest requirement to the pre-reorganization continuity of interest requirement as well.[408] There is some suggestion that the *Seagram* decision and the new continuity of interest regulations merely portend the demise of the continuity of interest requirement altogether.[409]

Another transaction qualifying as a statutory merger under Texas law that would otherwise be limited by the Code is popularly known as a "Morris Trust." The Fourth Circuit, in a case of the same name that was the first to address the tax treatment of the technique,[410] held that an acquisition of some but not all of a corporation's assets following a spin-off of the unwanted assets to the target corporation's shareholders was tax-free.[411] In the Taxpayer Relief Act of 1997,[412] however, Congress amended § 355 to make

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404. *See id.* at 91.

405. *See id.* at 101-02.

406. *See* Continuity of Interest, 61 Fed. Reg. 67512 (1996) (codified at Treas. Reg. § 1.368-1(e)(1)(i)) (proposed Dec. 23, 1996).

407. *See* Treas. Reg. § 1.368-1(e)(1)(i) (1998) ("[A] mere disposition of stock of the issuing corporation received in a potential reorganization to persons not related ... to the issuing corporation is disregarded.").

408. *See id.* ("For purposes of the continuity of interest requirement, a mere disposition of stock of the target corporation prior to a potential reorganization to persons not related ... to the target corporation or to persons not related ... to the issuing corporation is disregarded ...."); 1 GINSBURG & LEVIN, *supra* note 7, § 610.

409. *See, e.g.*, Miller, *supra* note 230.

410. *See* Commissioner v. Morris Trust, 367 F.2d 794 (4th Cir. 1966); *New Morris Trust Provisions Have Broad Reach*, 75 TAXES 658 (1997).

411. *See Morris Trust*, 367 F.2d at 799-802 (holding that a state bank's spin-off of its insurance operations prior to a merger with a national bank, necessitated by a federal banking law bar on the conduct of insurance activities, was not taxable); *see also* Rev. Rul. 68-603, 1968-2 C.B. 148 (following the *Morris Trust* decision).

412. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1012(a), 1997 U.S.C.C.A.N.

spin-offs taxable to the selling corporation (but not to the shareholders of either the target or the seller) if done in connection with an acquisition of 50% or more of stock of the target corporation or any controlled corporation.[413] Congress's concern was that such Morris Trust transactions go too far toward permitting corporations to engage in business adjustments by permitting sales of corporate assets tax-free.[414] According to the Conference Committee Report issued upon the release of the Act, this was especially true in the case of so-called "leveraged" Morris Trust transactions.[415] In such transactions, the distributing corporation incurs debt and contributes the proceeds of the debt to a controlled corporation prior to the spin-off of the controlled corporation.[416] The spin-off thus separates the proceeds of the loan from the obligation to repay—simulating a transfer of cash—without triggering the requirement that such distributions of cash outside the corporate solution be recognized as gain under the rules governing consolidated groups.[417] Such leveraged Morris Trust transactions were becoming increasingly popular in the year preceding the congressional enactment.[418]

One Morris Trust transaction announced in April of 1997 may have prompted Congress to accelerate its consideration of a legislative fix to such transactions. In that transaction, Disney

(111 Stat.) 788, 914 (amending I.R.C. § 355(e)).

413. *See* I.R.C. § 355(e) (West Supp. 1998); *see also* Howard G. Krane & Keith E. Villmow, *Spin-Offs and Leverage*, 75 TAXES 679, 687 (1997) (describing the new § 355(e)).

414. The Treasury Department supported the Administration's proposal to amend § 355 by stating that "[c]orporate nonrecognition under section 355 should not apply to distributions that are effectively dispositions of a business." Department of the Treasury, *General Explanations of the Administration's Revenue Proposals, reprinted in* Sydney E. Unger, Association of the Bar of the City of New York, *New York Attorneys Oppose Morris Trust Legislation*, TAX NOTES TODAY, July 30, 1997, at 146-33, *available in* LEXIS, Fedtax Library, TNT File. Representative Bill Archer's introductory statement to the release of his proposed legislation stated that many recent Morris Trust transactions " 'are prearranged structures designed to avoid corporate level gain recognition. In essence, these transactions resemble sales.' " Unger, *supra*, at 146-33 (quoting from Representative Archer's introduction to H.R. 1365, renumbered H.R. 2014).

415. *See* Conference Report and Statement of Managers, H.R. 2014, 105 Cong., *in* 1997 Tax Legislation: Law, Explanation and Analysis (CCH) ¶ 11,170, at 1086 (July 31, 1997).

416. *See id.*

417. *See id.*

418. *See* James R. Saxenian, *A Post-Spin-Off Acquisition of the Controlled Corp.: The IRS' Misguided Position*, TAX NOTES TODAY, Apr. 21, 1997, at 76-79, (discussing the Viacom Letter Ruling, Priv. Ltr. Rul. 96-37-043 (June 17, 1996), in which the IRS blessed a Morris Trust transaction involving Viacom's contribution of $1.7 billion in preexisting debt to its cable television subsidiary whose stock was effectively acquired by Tele-Communications, Inc.), *available in* LEXIS, Fedtax Library, TNT File; Unger, *supra* note 407, at 146-33.

proposed to dispose of some newspapers that it had obtained in connection with the acquisition of Capital Cities and the ABC network while at the same time borrowing $1 billion and letting the debt obligation follow the newspaper assets.[419] The Treasury Department explained that "[t]here is a natural tension between ensuring the appropriate taxation of gain when a company disposes of its assets and allowing corporate restructurings to proceed in an efficient manner to ensure competitiveness in the global marketplace."[420] According to Treasury, bills introduced by Representative Bill Archer (R-Tex.) in the House of Representatives and by Senator William Roth (R-Del.) in the Senate "represent[ed] an appropriate balancing of those concerns."[421]

The Texas merger statute was explicitly designed to permit parties to accomplish a Morris Trust transaction in one step through a statutory merger rather than through a multi-step spin-off.[422] As Curtis Huff has explained, "[c]orporations in today's competitive environment must seek new and innovative ways of acquiring corporations and managing their assets and businesses. This often involves the division of a corporation among different entities that may more efficiently operate such assets and businesses."[423] Through a single plan of merger, two Texas entities can enter into an agreement in which the target entity spins-off the assets of the unwanted business and merges into the acquiring entity, all without relying on § 355 and therefore without being subject to the restrictions on Morris Trust transactions contained in the 1997 Act. The transaction must be effected pursuant to § 368(a)(1)(A), rather than pursuant to the triangular merger provisions, because the target corporation's spin-off will prevent the acquisition of substantially all of the properties as required for a tax-free forward subsidiary

419. The transaction was announced in April, right before the chairs of the Senate Finance Committee and the House Ways and Means Committee jointly announced the introduction of a bill to make Morris Trust transactions taxable. *See* Robert Stowe England, *Tax Beater*, CFO, May 1997, at 27, 27; *JCT Releases Statement Clarifying Morris Trust Legislation*, TAX NOTES TODAY, Apr. 21, 1997, at 76-53, *available in* LEXIS, Fedtax Library, TNT File.

420. Letter from Donald C. Lubick, Acting Assistant Secretary (Tax Policy), Department of Treasury, to Richard D. McCormick, Chairman and Chief Executive Officer, US WEST, Inc. (July 23, 1997), *in Treasury Supports Proposals to Limit Morris Trust Transactions*, TAX NOTES TODAY, July 3, 1997, at 128-32, *available in* LEXIS, Fedtax Library, TNT File.

421. *Id.*

422. *See* Huff, *supra* note 385, at 115 & n.24.

423. *Id.* at 116 n.27.

merger[424] and will prevent the surviving corporation from holding substantially all of its properties after the merger as required for a tax-free reverse subsidiary merger.[425] A Morris Trust statutory merger, however, should otherwise comply with the judicial doctrines imposed on A reorganizations. The most vulnerable point for attack by the IRS is the continuity of business enterprise requirement. The Treasury Regulations, however, only require that the acquirer "continue a significant line of business."[426] Thus, when a target corporation operates more than one line of business prior to a merger, a spin-off will not prove fatal. As long as the transaction is not used to transfer a secondary line of a company's business, such a Morris Trust-type transaction appears to meet all the formal requirements for nonrecognition under § 368(a)(1)(A).

Thus, with respect to a state merger statute such as that of Texas, the statutory merger requirement is over-inclusive. It potentially affords tax-free treatment to "mergers" effected pursuant to Texas law even though the definition of merger includes transactions that would normally be taxable sales or subject to a different statutory regime under the Code. As one prominent practitioner noted when the statutory merger requirement was first enacted, "[t]hat a merger or consolidation is statutory in nature does not imply that no sale in the guise of a genuine reorganization with consequent freedom from tax liability has occurred."[427] By continuing to assume that the statutory merger requirement serves as a proxy for some of the requirements imposed in B and C reorganizations, the Code is susceptible to abuse when the state merger statute falls short of these requirements.

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424. *See supra* note 6 (describing a forward subsidiary merger); *see also* I.R.C. § 368(a)(2)(D) (West Supp. 1998) ("The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as 'controlling corporation') which is in control of the acquiring corporation, of substantially all of the properties of another corporation shall not disqualify a transaction under paragraph (1)(A) or (1)(G) if . . . ."). The spin-off and merger will be stepped together by the IRS and will be treated as if the acquiring corporation acquired all of the target's properties except the properties to be spun-off. Unless the spin-off involves a de minimis amount of assets, the transaction will thus fail to qualify as a tax-free forward subsidiary merger.

425. *See* I.R.C. § 368(a)(2)(E) (providing that a reverse subsidiary merger of the controlling corporation's subsidiary into the target corporation with the target shareholders exchanging their stock for stock of the controlling corporation will not be disqualified "if—(i) after the transaction, the corporation surviving the merger holds substantially all of its properties"). Since the target's spin-off of a more than de minimis amount of its assets immediately prior to the merger will be stepped together with the merger, the target will fail to hold substantially all of its properties after the merger.

426. Treas. Reg. § 1.368-1(d)(2)(ii) (1998).

427. Latham, *supra* note 200, at 41.

The inevitable response to the theoretical possibility of a Texas end run around the Code is the contention that any loophole would soon be closed by the courts. Just as they did with respect to the 1921 Act's parenthetical clause, the courts would likely invent doctrines to ensure that a statutory merger does not qualify for reorganization treatment when a transaction fails to comport with the common law definition of a merger or consolidation. The courts would probably look to the Treasury Regulations, which specify that to qualify for A reorganization treatment "the transaction must be a merger or consolidation effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia."[428] Thus, a transaction must first constitute a "merger or consolidation" as those terms are commonly defined and then qualify for merger treatment under the relevant statutory scheme. Regardless of whether this Treasury Regulation is authorized under a plain reading of the statutory language, the attempt would defeat the aim of the drafters. By interjecting such a judicial gloss on the statutory language, the statutory merger requirement would lose what little bright-line test quality it may have retained after the extension of the continuity of interest requirement in *Roebling*.[429] Furthermore, given the fact that states have begun to enact merger statutes that rely on definitions of merger or consolidation that are completely at odds with the common law and popular notions of the terms, the statutory merger requirement can hardly be defended as a bulwark against tax avoidance. If we must rely upon the courts to protect against statutory mergers that abuse the tax-free treatment accorded reorganizations, then we may as well leave the matter to the discretion of the courts altogether.

3. Under-Inclusive

At the same time that the statutory merger requirement unjustifiably includes state merger statutes that are too expansive in their definition of a merger, it unnecessarily excludes transactions that arguably should be eligible for A reorganization treatment. Such transactions include: (1) "de facto mergers," or transactions treated as mergers by the courts; and (2) transactions effected under state reorganization statutes that accord merger-type effect and restrictions without defining the transactions as mergers.

428. Treas. Reg. § 1.368-2(b)(1) (1998).
429. *See supra* notes 304-13 and accompanying text (discussing *Roebling*).

a. De Facto Mergers

Although the only method of effecting a merger or consolidation under the grant or concession theory of the corporation is pursuant to state statute or legislative pronouncement,[430] this theory of state dominance over the powers and privileges of the corporate entity has fallen from favor.[431] With the increase in general incorporation statutes and the resulting ease in which individuals are able to obtain charters, the role of the state in creating the corporation and in endowing it with its power to merge or consolidate with another corporation has become much less significant.[432]

One acknowledgment of this paradigm shift is the recognition of the de facto merger doctrine by courts in many jurisdictions.[433] According to the Second Circuit, "[a] de facto merger occurs when one corporation is absorbed by another, but without compliance with the statutory requirements for a merger."[434] Courts have identified several elements that must be present in order for a transaction to be classified as a de facto merger: (1) continuity of business enterprise; (2) continuity of shareholder interest through the payment of solely stock consideration; (3) dissolution of the target corporation; and (4) the acquiring corporation's assumption of the target corporation's

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430. *See supra* notes 203-08 and accompanying text.

431. *See* Charles D. Watts, Jr., *Corporate Legal Theory Under the First Amendment:* Bellotti *and* Austin, 46 U. MIAMI L. REV. 317, 370 (1991) ("No longer is there any meaningful state involvement in the creation of a corporation. Mere ministerial recordation does not constitute a concession from the sovereign, although the establishment of a corporation, or its equivalent, is not possible without such ministerial action."); Note, *Constitutional Rights of the Corporate Person*, 91 YALE L.J. 1641, 1646 (1982).

432. *See* FRIEDMAN, *supra* note 102, at 191; *see also* ROBERT S. STEVENS & ARTHUR LARSON, CASES AND MATERIALS ON THE LAW OF CORPORATIONS 82 (1955) ("It is usually stated that the issuing official who is asked to file a certificate which on its face complies with the statutes has no discretion in the matter and that his act is purely ministerial . . . .").

433. *See, e.g.*, Keller v. Clark Equip. Co., 715 F.2d 1280 (8th Cir. 1983) (applying North Dakota law); Shannon v. Samuel Langston Co., 379 F. Supp. 797 (W.D. Mich. 1974); Pratt v. Ballman-Cummings Furniture Co., 549 S.W.2d 270 (Ark. 1977); Marks v. Minnesota Mining & Mfg. Co., 232 Cal. Rptr. 594 (Ct. App. 1986); Rath v. Rath Packing Co., 136 N.W.2d 410 (Iowa 1965); Appelstein v. United Bd. & Carton Corp., 159 A.2d 146 (N.J. Super. Ct. Ch. Div.), *aff'd*, 161 A.2d 474 (N.J. 1960); Gilbert v. Burnside, 216 N.Y.S.2d 430 (App. Div. 1961); Farris v. Glen Alden Corp., 143 A.2d 25 (Pa. 1958). This is not merely a modern development. In the first few decades of the twentieth century, courts looking to protect creditors of merged corporations occasionally relied upon the de facto doctrine. *See* Comment, *supra* note 246, at 263.

434. Arnold Graphics Indus., Inc. v. Independent Agent Ctr., Inc., 775 F.2d 38, 42 (2d Cir. 1985).

liabilities.[435] In cases in which the doctrine is enforced, it is used to ensure that parties comply with the statutory protections afforded to dissenting shareholders and to creditors in a statutory merger.[436] Even in those jurisdictions such as Delaware and Texas where it has been rejected by statute or by the courts, the de facto merger doctrine may still apply in certain situations.[437] Despite the fact that the de facto merger generally satisfies the judicial continuity requirements applied to reorganizations and the statutory protections that are afforded to dissenters and creditors, it will not qualify as a statutory merger. It is a merger effected privately, rather than pursuant to the corporation laws of a state.

b. State Reorganization Statutes: The California Example

Even in California, where the de facto merger doctrine has been adopted by statute and the protections normally accorded to statutory mergers have been explicitly extended to the de facto variety, such transactions are ineligible for A reorganization treatment because they are not defined as mergers under the statute. California's General Corporation Law includes a provision for a "reorganization" transaction that is broader than a merger. Under section 181 of the California statute, "reorganization" is defined as one of three transactions: (1) a "merger reorganization" effected pursuant to the statute;[438] (2) an "exchange reorganization," or the "acquisition by one corporation in exchange in whole or in part for its equity securities . . . of shares of another corporation if, immediately after the acquisition, the acquiring corporation has control of the other corporation;"[439] or (3) a "sale-of-assets reorganization," or the "acquisition by one corporation in exchange in whole or in part for its equity securities . . . or its debt securities . . . , or both, of all or substantially all of the assets of another corporation."[440] According

435. *See Keller*, 715 F.2d at 1291; *Marks*, 232 Cal. Rptr. at 598. Not coincidentally, these are the same elements originally thought to be necessary for tax-free reorganization status.

436. *See* 3 JAMES D. COX ET AL., CORPORATIONS § 22.7 (1995).

437. Most notably, the doctrine may apply in transactions in which there appears to be an attempt to defraud creditors. *See, e.g., id.* § 22.7, at 22.23 (citing Drug Inc. v. Hunt, 168 A. 87 (Del. 1933)); Finch v. Warrior Cement Corp., 141 A. 54 (Del. Ch. 1928)); Frank William McIntyre, Note, *De Facto Merger in Texas: Reports of Its Death Have Been Greatly Exaggerated*, 2 TEX. WESLEYAN L. REV. 593, 618 (1996).

438. CAL. CORP. CODE § 181(a) (West 1999).

439. *Id.* § 181(b).

440. *Id.* § 181(c). Both the exchange and sale-of-assets reorganizations also permit triangular reorganizations in which the acquiring corporation uses the stock or securities of its parent corporation. *See id.* §§ 181(b) & (c).

to one commentator, the California statute "attempts to minimize the long-standing technical distinctions between different forms of corporate reorganization, such as the distinctions found in the I.R.C. and in some SEC rules."[441]

One of the most significant features of the California reorganization statute is that it specifies the form of consideration. Both the "exchange" reorganization under section 181(b) and the "sale-of-assets reorganization" under section 181(c), despite its misleading name, stipulate that the exchange consideration must consist in whole or in part of the equity securities of the acquiring corporation.[442] A sale of corporate assets is not a "reorganization" in California if the consideration for the transaction does not consist of either cash, stock of the acquiring corporation or its parent, or inadequately secured debt securities that mature more than five years after the closing of the transaction.[443] Thus, the California statute addresses the fear that the sales were being characterized as tax-free reorganizations in the absence of a statutory merger requirement.

Although most reorganizations are not defined as mergers under California law, the statute and judicial interpretations provide many of the same protections that are characteristic of the statutory merger. Dissenters, for example, are offered a statutory means of receiving compensation instead of being forced to acquiesce in a fundamental corporate change. Under section 1201(a), a majority of the outstanding shares of each class of stock must approve the principal terms of a reorganization.[444] Those minority shareholders that refuse to accede to the wishes of the majority may require the corporation to purchase its shares at fair market value as of the day before the first announcement of the proposed reorganization under an appraisal remedy.[445] Moreover, although the statute does not expressly provide for the allocation of liabilities by operation of law as is done under a statutory merger, California courts have nonetheless inferred such protection for creditors of the constituent entities to a reorganization by applying the de facto merger doctrine.

441. HERBERT KRAUS, THE CALIFORNIA CORPORATION: LEGAL ASPECTS OF ORGANIZATION AND OPERATION, at A-33 (BNA Corp. Prac. Series No. 31-2d, 1997).

442. *See* CAL. CORP. CODE §§ 181(b) &(c).

443. *See* KRAUS, *supra* note 441, at A-33.

444. *See* CAL. CORP. CODE § 1201(a) (West 1999).

445. *See id.* §§ 1300(a), 1304 (West 1999). California's requirement that dissenters forgo post-announcement appreciation in value has caused some to discount the protection this procedure offers to dissenters. *See* 1 GINSBURG & LEVIN, *supra* note 7, § 805.2.2, at 8-35 & n.3.

In *Marks v. Minnesota Mining & Manufacturing Co.*,[446] for instance, a California court of appeals held that 3M was liable for punitive damages imposed on a corporation whose business, assets, and goodwill were acquired in exchange for 3M's stock and its agreement to assume certain specified liabilities.[447] Under the agreement between the parties, 3M only agreed to assume the target corporation's normal operating liabilities and the parties engaged in a reorganization rather than in a statutory merger under California law.[448] The court acknowledged that while the general rule is that a purchaser of assets does not automatically assume the seller's liabilities, including its tort liabilities, there are several exceptions to that rule.[449] One such exception, the de facto merger doctrine, was determined to be applicable to the case at bar.[450] According to the court, this exception applies " ' "where the consideration consists wholly of shares of the purchaser's stock which are promptly distributed to the seller's shareholders in conjunction with the seller's liquidation." ' "[451] Under this doctrine, the court held that when the target corporation was acquired, "as a matter of corporate law it carried with it all of its liabilities."[452] The court brushed aside the disclaimer in the parties' agreement for "unknown claims," reasoning that "[s]ince the disclaimer would have had no effect in a *statutory* merger, where, as here, all of the indicia of a de facto merger are present, the same result is entirely appropriate."[453] Creditors and dissenting shareholders thus receive the same protection under California's reorganization provisions as they do in a statutory merger.

Although California's reorganization provision contains many of the features that played a role in the original adoption of the statutory merger requirement, a statutory reorganization does not appear to qualify for nonrecognition treatment under § 368(a)(1)(A). The "exchange" or stock-for-stock reorganization and the "sale-of-assets" or stock-for-assets reorganization in sections 181(b) and (c) of the California statute are specifically distinguished from a "merger

446. 232 Cal. Rptr. 594 (Ct. App. 1986).
447. *See id.* at 599.
448. *See id.* at 598.
449. *See id.* at 597.
450. *See id.*
451. *Id.* (quoting Ray v. Alad, 560 P.2d 3, 7 (Cal. 1977) (quoting Shannon v. Samuel Langston Co., 379 F. Supp. 797, 801 (W.D. Mich. 1974))).
452. *Id.* at 599.
453. *Id.*

reorganization" under section 181(a).[454] Arguably, this fact should not matter since the same reasoning that might be used to reject statutory merger treatment for the Texas divisive merger suggests the acceptance of the California reorganization. The Treasury Regulations describe a statutory merger as a merger or consolidation effected pursuant to the corporation laws of a state, implying that a de facto merger conducted pursuant to the California General Corporation Laws should qualify as an A reorganization. It does not appear, however, that the courts or the IRS are willing to expand the concept to this extent, especially since California's stock-for-stock and stock-for-assets reorganization provisions are eligible for nonrecognition treatment as B or C reorganizations, respectively.[455] The problem with this argument, however, is that a transaction that otherwise satisfies the goals or concerns of the statutory merger requirement is forced to comply with the more difficult non-merger reorganization provisions for no other reason than the technical form chosen for the transaction under California and other local laws.[456]

III. OPTIONS FOR FEDERALIZING THE TAX-FREE MERGER

To the extent that nonrecognition treatment for mergers and consolidations is still justified,[457] and thus that any gain from stock and securities received in reorganizations should continue to be tax-deferred, it makes little sense to maintain a statutory merger requirement as a condition of a tax-free reorganization. There are at least three alternatives: (1) Congress could itself decide on a uniform set of common law criteria for mergers that could be imposed on parties seeking A reorganization treatment; (2) the A reorganization could be eliminated from the Code altogether; or (3) the statutory merger requirement could be excised from the Code and the definition of the phrase "merger or consolidation" could be left to

454. *See* CAL. CORP. CODE §§ 181(a), (b), & (c) (West 1999); KRAUS, *supra* note 441, at A-33.

455. *See* George v. Commissioner, 26 T.C. 396, 403-04 (1956). In *George*, the court found a transaction to be in substance a consolidation of a Louisiana corporation and a Mississippi corporation even though the transaction did not comply with a technical statutory requirement. However, the court would not evaluate whether the transaction qualified as an A reorganization because of the availability of nonrecognition treatment as a C reorganization. *See id.*

456. Other states also provide certain rights and remedies to dissenting shareholders in fundamental corporate changes not qualifying as statutory mergers. *See, e.g.*, Donald J. Brown & M. Daniel Waters, *Dissenters' Rights and Fundamental Changes Under the New Iowa Business Corporation Act*, 40 DRAKE L. REV. 733 (1991).

457. Whether nonrecognition treatment is still justified, either under the original principles or other, more modern justifications is the subject of another ongoing project.

the IRS and the courts.

A. *Redraft Section 368(a)(1)(A) to Include Certain Common Law Requirements*

The statutory merger requirement can be replaced with more directed language that replicates the type of state law features now thought to be inherent in the statutory merger. This result could be accomplished by redrafting the provision to capture explicitly certain fundamental features of a merger, such as requirements that: (1) the target shareholders receive stock consideration; (2) the merging entity dissolves; and (3) the surviving corporation assumes all liabilities.[458] The belief that such requirements were intrinsic to a statutory merger led the drafters of the Revenue Act of 1934 to consider it as a separate category.[459] Although there may be some disagreement in identifying and defining the fundamental elements of a merger or consolidation, it would not be an insurmountable obstacle.

Imposing an explicit stock consideration requirement for A reorganizations has both statutory precedent in the existing "solely for voting stock" rule for B reorganizations[460] and judicial precedent in the continuity of interest requirement.[461] Moreover, this suggestion has been made several times over the years. One commentator noted in 1981 that "[t]he most sensible approach would be to eliminate the judicial continuity of interest test and to amend the statute to provide a uniform consideration test for all kinds of corporate reorganizations," including the statutory merger.[462] In 1996, two committees of the Tax Section of the New York State Bar Association recommended that the application of the continuity of interest doctrine be limited to those reorganization transactions, such as A reorganizations and forward subsidiary mergers under § 368(a)(2)(D), for which the Code contains no explicit stock consideration requirement.[463] The committees suggested an 80% voting stock requirement based on the statutory merger's analogy to a C reorganization.[464]

458. *See supra* note 230.
459. *See supra* notes 230-55 and accompanying text.
460. I.R.C. § 368(a)(1)(B) (West Supp. 1998).
461. *See supra* notes 163-77 and accompanying text.
462. Faber, *supra* note 7, at 263.
463. *See* Corporations Comm. and Reorganizations Comm. of the N.Y. State Bar Assoc. Tax Section, *Postreorganization Continuity of Interest*, 73 TAX NOTES 481, 489 (1996).
464. *See id.* at 490.

An explicit dissolution requirement also would not be an unprecedented addition to the reorganization provisions. Dissolution is already imposed on the acquired party in a C reorganization under § 368(a)(2)(G).[465] Moreover, the Treasury Regulations issued to provide a definition of "reorganization" under the Revenue Act of 1918 specifically required the dissolution of a corporation the property or stock of which was acquired by another corporation pursuant to the reorganization.[466] While a dissolution requirement disappeared from administrative pronouncements after 1921,[467] the reference to dissolution as a feature of the reorganization survived amendments to the Treasury Regulations through those issued under the Revenue Act of 1926.[468] As discussed earlier, however, even after the Court finally determined that dissolution was not required for qualification as a parenthetical clause transaction, it was still thought to be necessary for the merger or consolidation.[469]

Moreover, the statutory merger provision is a poor method for enforcing a dissolution requirement. One contemporary treatise writer noted "that the difficulty arises from the fact that these terms, as applied to corporations, are inherently statutory. Dissolution . . . may be the effect of the procedure for merger or consolidation required by the statutes of one state, and not be the effect under the laws of another jurisdiction."[470] Replacing the statutory merger language with an explicit dissolution requirement would be a better means to enforce a uniform standard. This in fact may have been the implicit scheme in place prior to the adoption of the statutory merger requirement in the 1934 Act. In discussing the elimination of a

465. *See* I.R.C. § 368(a)(2)(G)(i) (West Supp. 1998). ("A transaction shall fail to meet the requirements of paragraph (1)(C) unless the acquired corporation distributes the stock, securities, and other properties it receives, as well as its other properties, in pursuance of the plan of reorganization."). The Secretary of the Treasury is authorized to waive this liquidation or dissolution requirement if, but for a legal or other force staying liquidation, it has liquidated substantively. *See id.* § 368(a)(2)(G)(ii); Rev. Proc. 89-50, 1989-2 C.B. 631-32. *See generally* BITTKER & EUSTICE, *supra* note 4, ¶ 12.24[4] (explaining the liquidation requirement); Johnson, *supra* note 8, at 334 & n.103 (discussing the rationale behind the liquidation requirement).

466. *See supra* note 124 and accompanying text. These are the predecessors of the modern B and C reorganizations.

467. *See* BAAR & MORRIS, *supra* note 204, at 71; *see also* Satterlee, *supra* note 28, at 644 ("It is significant that items (2) and (3) of the 1921 regulation omitted the requirement of dissolution present in the regulation under the 1918 Act, and did not introduce such requirement in item (6).").

468. *See* Treas. Reg. 69, art. 1574 (1926), *reprinted in* 137 U.S. REVENUE ACTS, *supra* note 31; Satterlee, *supra* note 28, at 641 (citing Treas. Reg. 69, art. 1574).

469. *See supra* note 235.

470. BAAR & MORRIS, *supra* note 204, at 72.

universal dissolution requirement in *Helvering v. Minnesota Tea Co.*,[471] one commentator suggested that the Court's opinion implied that dissolution, although not required, would permit a transaction resembling a merger or consolidation to be treated like a technical merger or consolidation rather than a parenthetical clause transaction.[472] Under the Code as currently drafted, explicitly imposing a dissolution requirement on A reorganizations would distinguish such a merger from a stock-for-stock reorganization in which the target remains a subsidiary of the acquirer and from a statutory merger in states such as Texas where dissolution is not required. The fact of dissolution may ease some concerns that a taxable sale or exchange, rather than a tax-deferred reorganization, has occurred.[473]

Finally, requiring an acquirer to assume all of the known and unknown liabilities of its target, although not presently required by any of the reorganization provisions, would not be a difficult rule to administer. The general rule is that an acquirer is not liable for the debts and liabilities of the transferring corporation, but this rule is subject to several exceptions, one of which is when the acquirer expressly or impliedly agrees to assume the transferring corporation's liabilities.[474] Determining whether such an assumption of liabilities has occurred is merely a matter of contract interpretation—something courts are well equipped to perform. This would ensure that creditors are protected before the parties are granted nonrecognition treatment.

B. *Remove the A Reorganzation from the Code Altogether*

Although replacing the statutory merger requirement with common law requirements for mergers or consolidations would

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471. *See supra* note 234.

472. *See* Hendricks, *supra* note 71, at 1217.

473. In the absence of a dissolution requirement, a statutory merger, for example, is merely a sale of some of a corporation's assets (but not necessarily "substantially all") in exchange for certain consideration, at least 50% of which is stock, although not necessarily voting stock. *See supra* notes 380-85 and accompanying text. The remainder of the corporation's assets conceivably can remain in the corporate solution and escape the corporate-level and shareholder-level taxes imposed on complete liquidations. *See* I.R.C. § 331 (1994) (shareholder tax); I.R.C. § 336 (West Supp. 1998) (corporate tax); *see also* William J. Turnier, *Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation*, 64 CAL. L. REV. 902, 916-20 (1976) (arguing that the continuity of interest test is necessary to prevent tax avoidance that is possible when the target survives the reorganization). *But see* Sandberg, *supra* note 69, at 107-08 & n.43 (arguing that dissolution has no relevance for tax purposes).

474. *See, e.g.*, Keller v. Clark Equip. Co., 715 F.2d 1280, 1289 (8th Cir. 1983).

address the disparity in results for parties seeking A reorganization status, it would not satisfy critics. The overall disparity among the various reorganization alternatives would remain. Eliminating the A reorganization from the Code altogether, however, would help reduce the disparity caused by the A reorganization's status as "the most lenient type of reorganization in terms of requirements that must be satisfied."[475] While the conditions to A reorganization treatment that develop in the absence of the statutory merger requirement are likely to minimize this overall disparity, preserving the A reorganization is clearly a second-best solution to the disparity that exists between the state law and non-state law types of reorganizations.

Removing the A reorganization has been proposed several times before. In 1958, an America Law Institute Tax Project and an ABA Subcommittee proposed to eliminate the A reorganization as a separate manner of obtaining nonrecognition treatment:

> (1) Two basic categories of tax-free unifying corporation reorganizations should be recognized—asset acquisitions and stock acquisitions. The rules for these acquisitions should be essentially the same. Statutory mergers and consolidations should be eliminated as a separate category with different rules, but instead, should be subsumed within the asset acquisition and specifically mentioned as such in the statutory language.[476]

This recommendation was eventually submitted to the House Ways

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475. 11 MERTENS, *supra* note 29, § 43.01; *see also* Joseph Curtis, *Statutory Mergers Are Tax-Favored*, 6 TAX L. REV. 102, 103 (1950) ("The stringent requirement that the transferor shall receive only voting stock, or at least 80 per cent of the voting stock of the acquiring corporation, is not applicable to a statutory merger as it is in the case of a merger not effected under state corporation laws."). Neither the "substantially all the properties" requirement nor the "solely for voting stock" requirement apply to A reorganizations, and continuity of interest has been found in mergers in which less than 40% of the consideration for the target stock consists of stock of the acquiring corporation. *See* John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935); *see also* Johnson, *supra* note 8, at 352-65 (arguing that Congress should require a strong "substantially all" test for A and B reorganizations, like the one required with C reorganizations).

In the context of the decision whether to permit single-member LLC mergers to qualify as A reorganizations, James Sowell, an attorney-adviser in the Treasury's Office of Tax Legislative Counsel, asked "[h]ow easy do we want it to be to accomplish an A reorganization? An A reorganization can be much more sale-like than other types of reorganizations." Sheppard, *supra* note 351, at 763.

476. Surrey, *supra* note 10, at 28; *see also* Edward J. Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX L. REV. 155, 156 (1959) ("The obvious aim [to abolishing the A reorganization] is to achieve uniformity in an area where, other things being equal, similar tax results should apply to corporations in similar situations.").

and Means Committee by the "Subchapter C Advisory Group," a collection of tax-centered organizations, but it was never adopted.[477] A similar proposal resurfaced in the early 1980s culminating in the preparation of a Senate Finance Committee report proposing the introduction of the Subchapter C Revision Act of 1985.[478] Noting the seemingly arbitrary manner in which different requirements are imposed on the A, B, and C reorganizations, the report concluded that "[n]o policy justification can be found for these and other distinctions."[479] Thus, the report recommended eliminating the multi-type reorganization system and replacing it with an elective system in which parties to transactions deemed to be "qualified" asset or stock acquisitions would be accorded carryover basis treatment, and thus deferral, unless the parties chose to elect cost-basis treatment.[480] Under this proposal, statutory mergers or consolidations, while potentially falling within the definition for the "qualified asset acquisition" category described in the report, would no longer be evaluated under a separate A reorganization category.[481] During the consideration of the Tax Reform Act of 1986, Congress directed Treasury to study the proposals outlined by the Senate Finance Committee and report back on their desirability.[482] As with the earlier reform efforts, however, the basic structure of reorganization provisions was never significantly altered.

The various proposals to collapse the reorganization provisions, and thus eliminate the A reorganization, have never become law in part because of the complexity of the suggested alternatives. The elimination of the A reorganization alternative has generally been proposed, not as a stand-alone measure, but as part of an overall effort to reform the reorganization provisions. As one observer complained when writing about the 1985 reform proposal, "these proposals simply constitute one new complex system of corporate tax being substituted for another. From this perspective, there is very little to recommend them. At least the present system is generally known and understood by practitioners."[483]

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477. *See Subchapter C Advisory Group Report, Hearings Before the House Comm. on Ways and Means*, 86th Cong. 553-62 (1959).

478. *See* STAFF OF SENATE COMM. ON FINANCE, 99TH CONG., FINAL REPORT ON THE SUBCHAPTER C REVISION ACT OF 1985 (Comm. Print 1985).

479. *Id.* at 38.

480. *See id.* at 50-51.

481. *See id.*

482. *See* Posin, *supra* note 13, at 665.

483. *Id.* at 668; *see also* William L. Cary, *Reflections upon the American Law Institute Tax Project and the Internal Revenue Code: A Plea for a Moratorium and Reappraisal*, 60

Even if proposals to eliminate the A reorganization are separated from the larger reform efforts, they also face conceptual and practical opposition. First, eliminating the A reorganization faces practical opposition from participants to statutory mergers that would not otherwise qualify as B or C reorganizations. The B reorganization's zero tolerance for non-stock consideration and the C reorganization's "substantially all the properties" requirement each would serve to deny nonrecognition treatment to transactions that would have formerly qualified as A reorganizations. While there may be sound reasons for such an outcome, the exclusion of a pre-existing exit strategy or the loosening of a current requirement would necessitate political strength that may not be present on this issue.

Second, proposals to eliminate the A reorganization altogether may never be fully embraced because of the commonly held belief that a merger is the prototypical reorganization provision. Transactions falling short of the common understanding of a merger or consolidation therefore appear to require closer attention. The expansion of the 1918 Act to grant nonrecognition treatment to stock acquisitions was "the subject of heated debate" in Congress because of the fear of some of the members that anything less than a merger or consolidation was the equivalent of a taxable sale.[484] More recently, the American Law Institute concluded that, although the underlying rationale was "debatable," a statutory merger should be classified as a "prima facie" carryover-basis acquisition under its proposed elective system because this best comported with taxpayer expectations.[485] Thus, even the reformers have been cognizant of the need to provide for the continued existence of the A reorganization in some form or another in any modified system.

Perhaps the answer is that a non-state law dependent A reorganization should be the only reorganization provision. When Milton Sandberg addressed the disparities introduced by the original adoption of the statutory merger requirement, he suggested that Congress should "leav[e] the word 'statutory' out of Part (A), omit[] Part (B), and leav[e] it to the courts to determine what constitute[s] a non-statutory merger or consolidation," and he further noted that "whatever the arguments against definition by the judiciary, they are more than matched by the danger that the present system will result

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COLUM. L. REV. 259, 260-61 (1960) (criticizing the complexity of the earlier reform efforts); Skillman, *supra* note 65, at 392 (same).

484. Miller, *supra* note 230, at 193 & n.14 (citing 61 CONG. REC. 6560, 6566 (1921)).

485. AMERICAN LAW INST., *supra* note 8, at 42.

in tax avoidance."[486] This alternative, however, is also likely to be opposed as introducing an unnecessary element of complexity. Although a single merger or consolidation standard would have the virtue of eliminating the disparities caused by the myriad of statutory requirements, it would lessen the predictability and certainty available under the current system. Transactions such as stock-for-stock or stock-for-assets transactions that have become mainstays of modern mergers and acquisitions would suddenly be without definition or standards. Unlike the merger and consolidation, that have commonly accepted definitions and that have been the subject of judicial interpretation, the stock-for-stock and stock-for-assets reorganizations appear to be pure creatures of the Code, and as such their definitions involve questions of policy. Realistically, practitioners would follow the existing requirements pending the development of authoritative judicial or administrative guidance. In these circumstances, collapsing the reorganization provisions into a modified version of the A reorganization is likely to be a painful transition to a system not greatly improved from the present one.

C. Leave the Definition to the IRS and the Courts

The simplest solution to implement is to remove the word "statutory" from § 368(a)(1)(A) and let the courts and the IRS resolve the issue. As a practical matter, qualification as a merger under state law would continue to serve as highly probative evidence of the existence of a merger for tax purposes. However, eliminating the requirement that mergers be effected pursuant to state law would negate the notion that qualification under state law was either necessary or sufficient for A reorganization treatment. The IRS would attempt to provide guidance for the definition of the terms "merger" and "consolidation" through the issuance of administrative pronouncements, while the courts would monitor the outer boundaries of the terms on a case-by-case basis. This flexible approach structured around general principles was advocated by T.S. Adams and the Treasury Department in 1924, but cast aside by Congress in favor of the detailed treatment recommended by A.W. Gregg in the Gregg Statement.[487]

Providing a common law definition for mergers and

486. Sandberg, *supra* note 69, at 117.

487. *See* Posin, *supra* note 31, at 1350; *see also supra* notes 284-89 (discussing the decision in 1934 to draft detailed rather than flexible provisions for the tax treatment of reorganizations).

consolidations would not be an unfamiliar task for the courts. Prior to the enactment of a statutory merger requirement in 1934, courts were often called upon to resolve disputes over whether a transaction constituted a merger or consolidation for purposes of the reorganization exemption in the Code.[488] As the Supreme Court in *Pinellas Ice & Cold Storage Co. v. Commissioner* noted, " '[i]t must be assumed that in adopting paragraph (h) Congress intended to use the words 'merger' and 'consolidation' in their ordinary and accepted meanings.' "[489] Ascertaining those "ordinary and accepted meanings" was therefore left to the courts. In *Cortland Specialty Co. v. Commissioner*, for example, the Second Circuit culled its own definitions of merger and consolidation from the common law authority on the subject. According to the court:

> A merger ordinarily is an absorption by one corporation of the properties and franchises of another whose stock it has acquired. The merged corporation ceases to exist, and the merging corporation alone survives. A consolidation involves a dissolution of the companies consolidating and a transfer of corporate assets and franchises to a new company. In each case interests of the stockholders and creditors of any company which disappears remain and are retained against the surviving or newly created company.[490]

From an examination of the statutory authority on the subject, the court concluded that the one characteristic that all of the state merger statutes have in common is the intent "to continue the interests of those owning enterprises, which have been merged or consolidated, in another corporate form."[491] A cash sale of a corporation's assets "without the retention of any interest by the seller in the purchaser is quite outside the objects of merger and consolidation statutes."[492] In determining the "general purpose" of contemporary state merger statutes, the court clearly had to ignore

488. *See, e.g.*, Helvering v. Minnesota Tea Co., 296 U.S. 378, 386 (1935); Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933); C.H. Mead Coal Co. v. Commissioner, 28 B.T.A. 599, 609, 610 (1933); Thomas v. Commissioner, 14 B.T.A. 1341, 1344 (1929).

489. *Pinellas*, 287 U.S. at 469 (quoting Pinellas Ice & Cold Storage Co. v. Commissioner, 57 F.2d 188, 190 (5th Cir. 1932)). While the Court in *Pinellas* approved of the proposition quoted above, it concluded that the parenthetical clause modified the ordinary and accepted meanings "so as to include some things which partake of the nature of a merger or consolidation but are beyond the ordinary and commonly accepted meaning of those words." *Id.* at 470.

490. Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939 (2d Cir. 1932).

491. *Id.*

492. *Id.*

statutes in states such as Arkansas, California, Florida, Nevada, Ohio, Tennessee, and Illinois.[493] The merger provisions in those states to varying degrees permitted the surviving corporation to distribute cash, notes, bonds, or other obligations in lieu of its stock.[494] Thus, by ignoring or refusing to consider such authority, the court's refusal to grant tax-free reorganization status to an exchange of property for short-term promissory notes could only be based on its own conclusion that "[s]uch a limitation [requiring a continuance of interest on the part of the transferor in the properties transferred] inheres in the conventional meaning of 'merger and consolidation,' and is implicit in almost every line of section 203 [of the Revenue Act of 1926] which we have quoted."[495] State merger statutes served as a useful starting point for a court's own interpretation, but statutes that conflicted with the consensus definition erected by the courts could not sanitize transactions that failed to meet the common law authority.

Moreover, since 1944 courts have used judicial doctrines such as the continuity of interest requirement in determining when a merger or consolidation effected pursuant to state law is also a statutory merger for purposes of the reorganization provisions.[496] The judicial requirements were originally justified as protection against parenthetical clause transactions that did not resemble mergers and consolidations. As the Court noted in *Minnesota Tea Co.*, the requirement that the target corporation's shareholders retain a "definite and material" or "substantial" continuing interest in the transferred business enterprise "is necessary in order that the result accomplished may genuinely partake of the nature of merger or consolidation."[497] When applied to statutory mergers, such doctrines became a judicial gloss on the meanings of merger and consolidation. For example, "cash mergers," or mergers in which the only consideration was cash, were permitted under the National Banking Act and the Banking Law of the State of New York in the 1950s, but

493. *See* Comment, *supra* note 156, at 141 & n.48; Weiss, *supra* note 72, at 632-33.

494. *See* Comment, *supra* note 156, at 141 & n.48; Weiss, *supra* note 72, at 632-33.

495. *Cortland Specialty Co.*, 60 F.2d at 940.

496. Since *Roebling v. Commissioner* and *Southwest Natural Gas Co. v. Commissioner*, courts have continued to reject any notion that qualification as a merger under state law is both a necessary and sufficient prerequisite to tax deferral. *See, e.g.*, Laure v. Commissioner, 70 T.C. 1087, 1102 (1978); American Bronze Corp. v. Commissioner, 64 T.C. 1111, 1123 (1975); Scott v. Commissioner, 48 T.C. 598, 603 (1967); *see also supra* notes 297-302 (discussing *Roebling*); *supra* notes 311-19 (discussing *Southwest Natural Gas Co.*).

497. Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935).

could not qualify as A reorganizations due to the application of the continuity of interest requirement.[498] In *Paulsen v. Commissioner*,[499] the Supreme Court held that the merger of a stock savings and loan association and a mutual savings and loan association failed the continuity of interest requirement for A reorganizations despite qualifying as a merger under Washington law.[500] According to the Court, the savings accounts and certificates of deposit of the mutual savings and loan association were too debt-like to satisfy the continuity of interest test even though they constituted the bank's only form of equity.[501] In arriving at such a conclusion, the Court had to determine the nature of the consideration and the effect of the transaction—the same determination the State of Washington had to make prior to issuing a certificate of merger under Washington law.[502] In such cases, the only items required under state law that are not addressed by the judicial doctrines themselves are purely ministerial filing procedures[503]—items which surely could be replicated on the federal level by the attachment of certain forms or statements of intention to a taxpayer's annual return. In effect, because of the common law requirements that such transactions have a business purpose and maintain continuity of proprietary interest and business enterprise, courts have been defining the meaning of the terms "merger" and "consolidation" since shortly after the statutory merger requirement was instituted.

Finally, leaving the task to the courts rather than to the states does not necessarily mean that practitioners attempting to design a tax-free merger or consolidation would be left adrift in a sea of uncertainty. As with many substantive provisions of the Code that are left undefined or in which local law concepts and definitions are superseded by a general federal tax law understanding,[504] the IRS

498. *See* Donald McDonald & Josiah Willard, *Tax Free Acquisitions and Distributions*, 14 INST. ON FED. TAX'N 859, 860 n.2 (1956).

499. 469 U.S. 131 (1985).

500. *See id.* at 135-36. The fact that the continuity of interest test has been codified in Treasury Regulations did not unduly prompt the Court's resolution of this case. The Court quoted extensively from *Minnesota Tea Co.*, *LeTulle*, *Pinellas*, and *Nelson* in deciding whether the consideration offered satisfied the continuity of interest test. *See, e.g.*, *id.* at 136, 140-42.

501. *See id.* at 138-40.

502. *See, e.g.*, WASH. REV. CODE ANN. §§ 23B.11.010, 23B.11.060 (West 1994); State *ex rel.* Carriger v. Campbell Food Mkts., Inc., 374 P.2d 435, 438 (Wash. 1962) (denying statutory merger status for a transaction that was in reality a sale of stock).

503. *See, e.g.*, WASH. REV. CODE ANN. § 23B.11.010 (plan of merger); *id.* § 23B.11.030 (action on plan of merger); *id.* § 23B.11.050 (filing articles of merger).

504. See the phrase "trade or business," which is used at many points in the Code.

would be free to issue administrative guidance that effectively announces its litigation position on the subject. Actions taken in conformity with IRS pronouncements are not often challenged and therefore are not left to the uncertainty of the judicial process. In fact, just this sort of administrative guidance was issued soon after the enactment of the reorganization provisions. In 1920, Wayne Johnson, Solicitor of Internal Revenue, issued an Opinion to address the distinction between a merger and a consolidation for purposes of determining the invested capital of the resulting corporation.[505] Citing common law authority, the Johnson concluded that a transaction between two corporations is a merger for federal income tax purposes if one of the corporations "retains its corporate existence and absorbs the other or others, which thereby lose their corporate existence. A consolidation in a strict legal sense is effected when a new corporation is created to take the place of the constituent corporations, which are themselves dissolved in the process."[506] Because the New Jersey statute under which the transaction was effected failed to make clear the distinction between the two, administrative guidance was necessary to clarify the definition of merger and consolidation for tax purposes.[507] More recently, the IRS issued similar guidance on the statutory merger requirement. In a private letter ruling, the IRS addressed a taxpayer's question regarding the tax characterization of a proposed acquisition of a

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E.g., I.R.C. § 62(a)(1) (West Supp. 1998); *id.* § 162; *id.* § 167(a)(1); *id.* § 469(c)(1)(A). An example of the Code's explicit disregard for local law is in the definition of "real property" for purposes of determining whether a real estate investment trust satisfies the requirement that at least 75% of the value of its total assets consists of "real estate assets," defined to mean real property. *Id.* § 856(c)(4). According to the regulations issued pursuant to § 856,

> [l]ocal law definitions will not be controlling for purposes of determining the meaning of the term "real property" as used in section 856 and the regulations thereunder. The term includes, for example, the wiring in a building, plumbing systems, central heating or central-air conditioning machinery, pipes or ducts, elevators or escalators installed in the building, or other items which are structural components of a building or other permanent structure. The term does not include assets accessory to the operation of a business, such as machinery, printing press, transportation equipment which is not a structural component of the building, office equipment, refrigerators, individual air-conditioning units, grocery counters, furnishings of a motel, hotel, or office building, etc., even though such items may be termed fixtures under local law.

Treas. Reg. § 1.856-3(d) (1998).

505. *See* Sol. Op. 4, 2 C.B. 307, 307-10 (1920).

506. *Id.* at 307 (citing Lee v. Atlantic Coast Line R.R. Co., 150 F. 775, 787 (C.C.D.S.C. 1906), *rev'd sub nom. on other grounds*, Atlantic Coast Line R.R. Co. v. Dunning, 166 F. 850 (4th Cir. 1908)).

507. *See id.* at 308.

company through a reverse subsidiary merger followed immediately by an upstream merger of the newly acquired target subsidiary into the acquiring corporation.[508] The taxpayer represented to the IRS that: (1) the upstream merger would otherwise qualify as a tax-free liquidation of a wholly owned subsidiary under § 332; and (2) a direct merger of the target into the acquiring corporation would qualify as a valid A reorganization.[509] Based on these representations, the IRS ruled that the two transactions would be treated as one statutory merger if they were found to constitute individual steps in an integrated transaction.[510] Despite the fact that the acquirer and the target would not actually merge together under state law, the IRS was willing to deem a state-law merger to have occurred.[511]

Thus, leaving the definition of merger or consolidation to the IRS and the courts would resolve the A reorganization's internal inequities without suffering from either the complexity or the conceptual difficulties of the other alternatives. This modest solution essentially acknowledges the preexisting judicial and administrative role in the definition of the terms "merger and consolidation." The innovation is to remove the limits to that interpretive role that have contributed to the A reorganization's demise as a useful standard for nonrecognition treatment.

CONCLUSION

Many reformers, both in academia and in the halls of Congress, hold out the hope that the entire system of double taxation of corporate income will someday be replaced by the integration of corporate-shareholder income taxation.[512] Intermediate steps designed to make the current system more desirable, such as the expansion and simplification of nonrecognition treatment for corporate reorganizations, may be rejected as a tool of quiescence

508. *See* Priv. Ltr. Rul. 98-04-038 (Jan. 23, 1998).

509. *See id.*

510. *See id.*

511. Previously, the IRS had denied statutory merger treatment in the similar, but not identical, situation of a forward subsidiary merger followed by a liquidation. *See* Rev. Rul. 72-405, 1972-2 C.B. 217 (treating the merger as a C reorganization).

512. *See, e.g.*, Michael L. Schler, *Taxing Corporate Income Once (or Hopefully Not at All): A Practitioner's Comparison of the Treasury and ALI Integration Models*, 47 TAX L. REV. 509 (1992); Scott A. Taylor, *Corporate Integration in the Federal Income Tax: Lessons from the Past and a Proposal for the Future*, 10 VA. TAX REV. 237 (1990); George K. Yin, *Corporate Tax Integration and the Search for the Pragmatic Ideal*, 47 TAX L. REV. 431 (1992).

and as a distraction from more significant reform proposals.[513] This fact may account for some of the opposition to previous reform efforts and may constitute the most controversial aspects of any proposal to modify § 368(a)(1)(A) by eliminating the statutory merger requirement. However, such opposition overstates the connection between the tax-free reorganization provisions and the taxation of corporate dividends and ironically serves to thwart the de facto integration of business and individual income taxation.

The adoption of nonrecognition treatment for reorganizations predates the adoption of a general tax on corporate dividends.[514] Two years after the adoption of the statutory merger requirement, Congress began to tax individual shareholders on corporate dividends, but even then the corporation was allowed a deduction for the payment of such dividends, effectively elevating the shareholder's return to compensate for the tax.[515] It was not until 1939 that Congress effectively eliminated the integration of the corporate income tax.[516] Thus, the reorganization provisions and the statutory merger requirement could not have been related to concerns over the effects of the double taxation of corporate income. The two issues are neither historically nor symbolically tied together. To the extent that the reorganization provisions provide shareholders with a method of deferring tax, it has never been premised on the size of the tax due or the paucity of post-tax corporate income left to distribute.

Moreover, removal of the statutory merger requirement is an important part of the de facto integration of business/investor taxation begun with the check-the-box regulations. By permitting non-corporate business entities, including limited liability companies, to elect pass-through taxation, Congress effectively made integration a choice for many non-publicly traded businesses.[517] As more and

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513. *See* AMERICAN LAW INST., *supra* note 8, at 1-4 (discussing the relationship between many of the ALI proposals and the particular forms of general integration); Renato Beghe, *The American Law Institute Subchapter C Study: Acquisitions and Distributions*, 33 TAX LAW. 743, 746 (1980) (discussing the criticism that "the adoption of Draft No. 2 might obstruct the enactment of a more complete integration system"). For instance, when Treasury submitted its long-awaited study of the Subchapter C reform proposals, it advocated general integration of the corporate-shareholder taxes, foregoing entirely any discussion of the reorganization proposals. *See* Johnson, *supra* note 8, at 364-65 & n.271.

514. Under the 1913 Act, corporate dividends were not subject to the normal tax, although they were subject to the surtaxes imposed at higher marginal rates. *See* Tariff Act of 1913, ch. 16, § II(B), 38 Stat. 167-68.

515. *See* Revenue Act of 1936, ch. 690, § 27, 49 Stat. 1665, 1648.

516. *See* Taylor, *supra* note 512, at 241.

517. The gradual integration of the corporate tax is not uniformly applauded because it

more individuals use such corporate-like pass-through entities to conduct their business ventures,[518] the integration issue may be reduced to a choice based on shareholder return. Businesses that continue to conduct their enterprises in corporate form will either have to justify their status by greater returns or elect to be taxed as a partnership. One manner in which the tax system continues to interfere with this choice of entity decision, however, is the statutory merger requirement. Investors generally seek at least two features in an investment: (1) high current post-tax returns; and (2) the ability to dispose of their investments and receive value in exchange. As to the first feature, pass-through entities potentially offer higher returns than C corporations because they avoid the entity-level tax to which C corporations are subject. As to the second feature, however, the non-publicly traded pass-through entity may still be at a disadvantage because of the removal of one exit strategy—the tax-free reorganization—that could permit an investor to maximize the value he receives in an exchange. Entities that are not able to engage in tax-free reorganizations with state law corporations because they are not state law corporations themselves are thus less likely to attract investment that would otherwise reward their pass-through status. The removal of the statutory merger requirement is therefore actually an important part of the incremental integration of business/investor income taxation.

Finally, the removal of the statutory merger requirement is more than a mere technical fix in the underbrush of a larger reform of corporate taxation. It is symbolically connected with the check-the-box regulations in de-linking the Code from the historical and formalistic requirements of state law. This general trend toward the "federalization" of the Code[519] evidences an intent to base federal decisions to tax on uniform criteria that are, whenever possible, independent from non-tax local law concerns. For example, one of the primary concerns involved in the decision to change from an individual taxpaying unit system to a marital taxpaying unit system

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also is accused of frustrating efforts toward elimination of the corporate tax altogether. *See* Karen C. Burke, *The Uncertain Future of Limited Liability Companies*, 12 AM. J. TAX POL'Y 13, 59 (1995); Susan Pace Hamill, *The Limited Liability Company: A Catalyst Exposing the Corporate Integration Question*, 95 MICH. L. REV. 393, 397 (1996); Ketema, *supra* note 348, at 1675.

518. *See* RICHARD A. WESTIN ET AL., FEDERAL INCOME TAXATION OF BUSINESS ENTERPRISES 3 (1995).

519. This is not to be confused with the tax federalism that is discussed in the context of state and local taxation. *See, e.g.*, Daniel Shaviro, *An Economic and Political Look at Federalism in Taxation*, 90 MICH. L. REV. 895 (1992).

was to reconcile differences in treatment between community property and common law states.[520] Closer to home, the addition of non-merger reorganizations was designed to unify the treatment of mergers in states with and without merger statutes. Viewed in this context, the removal of the statutory merger requirement is necessary on grounds independent of those used to justify the reform of corporate taxation. It is an attempt to lessen the Code's anachronistic reliance on state corporation laws.

520. *See* Boris I. Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1412-14 (1975); Lawrence Zelenak, *Marriage and the Income Tax*, 67 S. CAL. L. REV. 339, 342-43 (1994).