AMALGAMATIONS OF MULTIPLE OPERATING CORPORATIONS: SECTION 368(a) (1) (F) AND REVENUE RULING 69-185

In 1969 Revenue Ruling 69-185[1] was promulgated stating that a combination of two or more commonly owned operating corporations into one corporation could not qualify as an F-Type reorganization pursuant to Section 368(a)(1) of the Internal Revenue Code of 1954.[2]

Several recent cases indicate that this Ruling may be of doubtful validity.[3] Further, it remains to be seen whether Revenue Ruling 69-185 will be applied to a situation where two or more corporations are liquidated under Sections 331 and 337, which sections generally allow the gain from liquidations to be treated as capital gains. If such a liquidation is followed by a reincorporation, the Service will usually want to argue that the liquidation and reincorporation are merely successive steps in a single transaction. The taxpayer, on the other hand, will want to divorce the liquidation from the reincorporation.[4] A broad reading of § 368(a)(1)(F) would allow the Service to argue that the liquidation-reincorporation was really only a change in the "form, identity or plan of organization" of the corporation and therefor only an F reorganization. If Revenue Ruling 69-185 is applied to this liquidation-reincorporation, it would appear to assist the tax-avoidance scheme of liquidation-

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[1] Rev. Rul. 69-185, 1969 INT. REV. BULL. NO. 16, at 11.

[2] Section 368(a)(1) of the INT. REV. CODE of 1954, defines the term "reorganization" to mean six (and only six) forms of corporate adjustments. BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.02 (2d ed. 1966) paraphrase the statute as follows:

> Type A. A statutory merger or consolidation.
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> Type B. The acquisition by one corporation, in exchange solely for all or a part of its voting stock (or the voting stock of a parent corporation) of stock of another corporation, if the first corporation has control of the second immediately after the acquisition.
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> Type C. The acquisition by one corporation, in exchange for all or part of its voting stock (or the voting stock of a parent corporation), of substantially all of the property of another corporation. The consideration given by the acquiring corporation must be solely voting stock, except that liabilities of the acquired corporation may be assumed, property may be taken subject to liabilities, and a limited amount of money or other consideration may be paid.
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> Type D. A transfer by a corporation of all or part of its assets to another corporation, if immediately after the transfer the transferor, its shareholders (including its former shareholders), or both in combination are in control of the transferee corporations; but only if the stock or securities of the transferee corporation are distributed, under the plan, in a transaction which qualifies under § 354, § 355, or § 366.
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> Type E. A recapitalization.
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> Type F. A mere change in identity, form or place of organization, however affected.

[3] Davant v. Comm'r, 43 T.C. 540 (1965), *aff'd*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); Pridemark, Inc. v. Comm'r, 42 T.C. 510 (1964), *rev'd*, 345 F.2d 35 (4th Cir. 1965); Estate of Stauffer, 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968); Association Machine v. Comm'r, 48 T.C. 318 (1967), *rev'd*, 403 F.2d 622 (9th Cir. 1968).

[4] *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.22 (2d ed. 1966) for some tax avoidance purposes of the liquidation—reincorporation device.

reincorporation since it seems to narrow the scope of the F reorganization.

Revenue Ruling 69-185 is also contrary to earlier Rulings issued in connection with § 381(b)[5] which specifies the taxable year of the distributor or transferor corporation in a reorganization. Section 381(b) provides that "the taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer" except in the case of an acquisition which qualifies as an F reorganization. Revenue Ruling 57-276[6] indicated the taxable year which was to be used in the case where a corporate reorganization met the requirements of both § 368(a)(1)(F) and § 368(a)(1)(A) of the Internal Revenue Code of 1954. The fact pattern presented in the request for the ruling involved two existing corporations which reincorporated under the laws of a state other than that of original incorporation. Each corporation organized a new corporation in the other state, and each corporation then merged into its newly organized corporation under the applicable merger statutes of the states concerned. The first of the existing corporations was a single corporation with no subsidiaries. The second of the existing corporations was the parent corporation of an affiliated group of corporations which had filed consolidated income tax returns. Each merger was held to qualify as a reorganization under both § 368(a)(1)(A) and § 368(a)(1)(F) of the Code.[7]

Revenue Ruling 57-276 stated that:

> Often a reorganization under section 368(a)(1)(F) of the Code will meet the requirements of subparagraphs (A), (C), or (D) of section 368(a)(1). It is believed that it was not the intention of Congress in enacting section 368(a)(1) of the Code to hold that just because a reorganization meets some other provision of section 368(a)(1) the provisions of subparagraph (F) of that section are not complied with even though the transaction also qualifies under subparagraph (F). Taking a contrary view under the 1954 Code would, for all practical purposes, defeat the

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[5] INT. REV. CODE of 1954, § 381(b) provides:
Operating rules.—Except in the case of an acquisition in connection with a reorganization described in subparagraph (F) of § 368(a)(1)—
(1) The taxable year of the distributor or transferor corporation shall end on the date of distribution or transfer.
(2) For purposes of this section, the date of distribution or transfer shall be the day on which the distribution or transfer is completed; except that, under regulations prescribed by the Secretary or his delegate, the date when substantially all of the property has been distributed or transferred may be used if the distributor or transferor corporation ceases all operations, other than liquidating activities, after such sale.
(3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

[6] REV. RUL. 57-276, 1957-1 CUM. BULL. 126.

[7] *Id.* at 127.

> provisions of section 381(b) of the Code, since many section 368(a)(1)(F) reorganizations meet some other provisions of section 368(a)(1).[8]

This ruling then held that where a corporate reorganization qualifies as an F-Type reorganization, § 381(b) of the Code requires the acquiring corporation to file a single tax return for the full taxable year notwithstanding the fact that such a reorganization also qualified under another provision of § 368(a)(1) of the Code.[9]

In response to a similar request in 1958 where a parent corporation with two subsidiaries formed a new corporation in a different state which then absorbed the parent and two subsidiaries in a statutory merger,[10] Revenue Ruling 58-422[11] stated that Revenue Ruling 57-276 is applicable in all cases where there is no change in the existing shareholders and no change in the assets of the corporations involved and that the surviving corporation need only file one return under the F-Type reorganization exception of § 381(b)(1).

The first significant judicial mention of § 368(a)(1)(F) was in *Pridemark, Inc. v. Commissioner*[12] where a group headed by Eugene Blitz owned two corporations (Pridemark Maryland and Pridemark Connecticut) which had an exclusive contract to sell Golden Key Mobile Homes. Due to disagreements between Pridemark and Golden Key, Pridemark sold to Golden Key their entire business as a going concern with the exception of $284,000 worth of assets (including the name Pridemark).[13] Pridemark then liquidated and distributed the assets to its shareholders who reassigned them to Eugene Blitz in trust. Eugene Blitz and the other shareholders subsequently formed a new corporation, Pridemark Enterprises, Inc., and obtained a sales contract to sell Hilco Homes. The trust assets were then transferred to the new corporation. The taxpayer claimed that Pridemark Enterprises, Inc., was a new corporation and that the cash distributions upon the liquidation of Pridemark were taxable at capital gains rates.[14] The Commissioner argued and the Tax Court held, however, that the supposed liquidation of Pridemark Maryland and Pridemark Connecticut and the formation of Pridemark Enterprises, Inc., was actually a type F reorganization.[15] The fed-

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[8] *Id.* at 127.

[9] § 381(b) also prohibits the carry-back of post transfer losses to pre-transfer earnings except for § 368(a)(1)(F) reorganizations, INT. REV. CODE of 1954, § 381(b).

[10] A statutory merger is a § 368(a)(1)(A)-type reorganization, INT. REV. CODE of 1954, 368(a)(1)(A).

[11] Rev. Rul. 58-422, 1958-2 CUM. BULL. 145.

[12] 42 T.C. 510 (1964), *rev'd*, 345 F.2d 35 (4th Cir. 1965).

[13] These assets were primarily fixtures located at the home office in Baltimore.

[14] § 331 treats amounts received in complete liquidation of a corporation as payment in exchange for stock and hence taxable at capital gains rates, INT. REV. CODE of 1954, § 331.

[15] Pridemark, Inc. v. Comm'r, 42 T.C. 510 (1964). Section 356 treats sums received in a reorganization at ordinary income rates, INT. REV. CODE of 1954, § 356.

eral court found that the liquidation of Pridemark and the incorporation of Pridemark Enterprises, Inc., did not possess the continuity of interest necessary for an F-Type reorganization since the shareholder ratios were different.[16] The important point to be noted from this case is that a multi-corporate amalgamation into a single entity were held to be an F-Type reorganization.[17]

In *Davant v. Commissioner*[18] the owners of two corporations, Warehouse (which stored rice) and Water (which provided irrigation service for rice farms), transferred the assets of Warehouse to a dummy third party who immediately resold them to Water; Warehouse was then liquidated. The Tax Court disregarded the dummy conduit and held the transfer to be a § 368(a)(1)(D) type reorganization. The Commissioner of Internal Revenue had argued, and the Federal Court held, however, that the transaction was both a § 368(a)(1)(D) and a § 368(a)(1)(F) type reorganization. The Federal Court stated that an F-Type reorganization can apply where the corporate enterprise continues uninterrupted except for the distribution of some liquid assets or cash.[19] The court found that since this was a reorganization and not an actual liquidation the throw-off of liquid assets to the shareholder would be taxable at ordinary income rather than capital gains rates to the extent of the total combined earnings and profits of Warehouse and Water.[20] The court agreed with the Commissioner of the Internal Revenue that this transaction could be classified as more than one type of a § 368(a)(1) reorganization.

If these examples are put together, it can be seen that the government has consistently argued that a given set of facts may be both an F-Type reorganization and another § 368(a)(1)-type of reorganization so long as the type-F criteria are met[21] and that an F-Type reorganization can apply to a multi-corporate situation.[22]

A change of position was taken by the Internal Revenue Service in *Estate of Stauffer*[23] and in *Associated Machine v. Commissioner.*[24] In

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16 Pridemark, Inc. v. Comm'r, 345 F.2d 35 (4th Cir. 1965). Continuity of interest and no substantial change in property interest are requirements for a § 368(a) (1) (F)-Type reorganization, Davant v. Comm'r, 366 F.2d 874, 83-84 (5th Cir. 1966).

17 This is contrary to the position taken in Rev. Rul. 69-185 which concluded that an F-Type reorganization only applied to an unicorporate transfer.

18 Davant v. Comm'r, 43 T.C. 540 (1965), *aff'd*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967).

19 Davant v. Comm'r, 366 F.2d 874 (5th Cir. 1966).

20 Section 331 treats amounts distributed in complete liquidation of a corporation as payment in exchange for the stock, while § 356 treats property received in a reorganization as a dividend, INT. REV. CODE of 1954, §§ 331, 356.

21 *See* Davant v. Comm'r, 43 T.C. 540 (1965), *aff'd*, 366 F.2d 874 (5th Cir. 1966).

22 *See* Pridemark, Inc. v. Comm'r, 42 T.C. 510 (1964), *rev'd*, 345 F.2d 35 (4th Cir. 1965); Rev. Rul. 57-276, 1957-1 CUM. BULL. 126, 127; Davant v. Comm'r, 43 T.C. 540 (1965), *aff'd*, 366 F. 2d 874 (5th Cir. 1966).

23 48 T.C. 277 (1967), *rev'd*, 403 F.2d 611 (9th Cir. 1968).

Stauffer, the taxpayer owned three corporations located in three different states (California, Illinois and New York), all of which sold reducing equipment. The taxpayer organized a fourth corporation (Stauffer New Mexico) and merged the original corporations into the fourth. He then claimed that this was an F-Type reorganization and that he was entitled to carry back post-merger losses of Stauffer New Mexico to the pre-merger earnings of one of the original three corporations per the exception for F-Type reorganizations in § 381(b)(3).[25]

In *Associated Machine*, a California corporation (J & M Engineering), merged with another California corporation (Associated Machine Shop) to form Associated Machine, Inc. All three corporations were owned by the taxpayer. The taxpayer then tried to carry back the post-merger losses of Associated Machine, Inc., to the pre-merger earnings of Associated Machine Shop per § 381(b)(3). In *Stauffer*, the government argued, and the Tax Court held (reversed by the Court of Appeals), that F-Type reorganizations only apply to a uni-corporate situation; that is, an F-Type reorganization, is not applicable to an amalgamation of multiple operating corporations. The Commissioner felt that the absence of an exception for F-Type reorganizations in § 381(c)(1)[26] indicated that the multi-corporate F-Type reorganizations were not intended.[27] The Court of Appeals, in reversing the Tax Court, found that § 368(a)(1) reorganizations are not mutually exclusive. It noted that as originally enacted § 368(a)(1)(F) read "a mere change in identity, form, or place of organization of a corporation."[28] This section was changed in 1924 by dropping the words "of a corporation."[29] This change would arguably indicate that the section was meant to apply to multi-corporate changes. If Stauffer California had reincorporated into Stauffer New Mexico and then acquired Stauffer Illinois and Stauffer New York, the losses of Stauffer New Mexico could have been carried back to the pre-reincorporation earnings of Stauffer California. Likewise, if Stauffer California had acquired Stauffer New York and Stauffer Illinois and then reincorporated into Stauffer New Mexico, the post-

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[24] 403 F.2d 622 (9th Cir. 1968).

[25] Except for an F-Type reorganization, the corporation acquiring property in a § 368(a) (1) reorganization is not entitled to carry back a net operating loss for a taxable year ending at the date of distribution or transfer to a taxable year of the distributor or transferor corporation, INT. REV. CODE of 1954, § 381(b)(3).

[26] Section 381(c)(1) prohibits the carry-back of pre-merger losses of the transferor corporation to the pre-merger earnings of the transferee corporation.

[27] A uni-corporate F-Type reorganization would have no second corporation to transfer pre-merger losses to and thus require no exception. *See* Rev. Rul. 69-185, 1969 INT. REV. BULL. No. 16 at 11; Estate of Stauffer, 403 F.2d 611, 620 (9th Cir. 1968).

[28] Int. Rev. Act of 1921, §§ 202(c)(2), Act of Nov. 23, 1921, ch. 136, § 202(c)(2), 42 Stat. 230; *see* Estate of Stauffer, 403 F. 2d at 616 (1968).

[29] Int. Rev. Act of 1954, § 203(h)(1)(D), Act of June 2, 1924, ch. 234, § 203(h)(1)(d), 43 Stat. 253.

merger losses could be carried back.[30] The court could not distinguish between these situations and the actual fact pattern in Stauffer. The court stated that the Commissioner of Internal Revenue was arguing that this case was distinguishable from *Davant* because it dealt with carryback rather than gain. The court said:

> In effect, he [the Commissioner of Internal Revenue] says that an "F" reorganization is one thing when the issue is treatment of gain and another when the issue is loss carry-back. The Commissioner's very position is illustrative of the taxpayer's paradox herein.
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> We do not see how the definitive principles of an "F" reorganization can change from one case to another, from one context to another, dependent upon which position the Commissioner of Internal Revenue prefers. While the factual situation "which gives rise to a determination in a given case will invariably differ, the standards by which the determination is to be made cannot. An "F" reorganization is just that, and tax consequences flow from that determination, not vice-versa.[31]

The court also held that there was no need for Congress to give further favorable treatment to F-Type reorganizations by granting an exception for the F-Type reorganization in § 381(c)(1) since this would be a horizontal transfer of losses and earnings and would lack the unity of interest necessary in an F-Type reorganization. On this point, in *Associated Machine*, the Court of Appeals felt that § 381(b)(3) and § 381 (c)(1)(A) were mirror images regarding carry-back and carry-forward for the F-Type reorganizations. The Court of Appeals found for the taxpayer in both *Stauffer* and *Associated Machine* and ruled that § 368(a) (1) reorganizations are not mutually exclusive, and that F-Type reorganizations can apply to multi-corporate amalgamations.

The Commissioner, however, did not give up after these two setbacks. In Revenue Ruling 69-185,[32] the Commissioner stated that he would not follow the *Stauffer* and *Associated Machine* decisions in the Ninth Circuit and that portion of *J. E. Davant* in the Fifth Circuit which indicated that a combination of two or more commonly-owned operating corporations may qualify as an F-Type reorganization. The ruling repeated the arguments advanced in *Stauffer* and *Associated Machine* and cited Regulations 1.381(c)(1)-1(b),[33] examples 1 and 2, and Regulations 1.381 (b)-1(a)(1) and 1.381(b)-1(a)(2)[34] as support for his argument.

It appears that in Revenue Ruling 69-185 the IRS has abandoned a significant weapon against the situation where the owners of a corporation liquidate under § 337 of the Internal Revenue Code of 1954 and

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[30] *See* Estate of Stauffer, 403 F.2d 611, 619 (9th Cir. 1968).

[31] *Id.*

[32] Rev. Rul. 69-185, 1969 INT. REV. BULL. NO. 16, at 11.

[33] Treas. Reg. § 1.381(c)(1)-1(b) (1960).

[34] Treas. Reg. § 1.381(b)-1(a)(1) (1960).

then reincorporate while retaining a substantial portion of the liquid assets of the liquidated corporation at capital gains rates.[35] If the liquidation-reincorporation could qualify as an F-Type reorganization, then the throw-off of the liquid assets, upon liquidation, to the shareholders of the old corporation would be taxed at ordinary income rates as boot[36] since the corporation substance has continued practically unchanged.

If the taxpayer in *Stauffer* had liquidated his three corporations (Stauffer California, Stauffer New York and Stauffer Illinois) in a Section 337 statutory liquidation and then promptly reincorporated into Stauffer New Mexico, the government could not argue, as it did in *Pridemark*, that the transaction was an F-Type reorganization and that the cash throw-off should be taxed at ordinary income rates. Instead the transaction would be taxed at capital gains rates per Sections 331 and 337 of the Internal Revenue Code.[37] This would be particularly true if the corporations involved did not have fixed assets but only liquid assets. For example, a chain of commonly owned service corporations, like TV repair shops, can sell off their parts inventories at liquidation and then purchase new parts at reincorporation into a single entity. If the court were to follow Revenue Ruling 69-185 and hold that an F-Type reorganization did not apply to this multi-corporate transaction then the hypothetical taxpayer would be able to allow cash to accumulate and then take it out of the corporation by this liquidation-reincorporation method at capital gains rates.[38] It remains to be seen what position the Internal Revenue Service will take when such a case occurs.

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[35] BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.22 (1966, Supp. 1968).

[36] Boot is the amount received in the reorganization, other than stock or securities of the transferee corporation, and is generally taxed at ordinary income rates, INT. REV. CODE of 1954, § 356. *See* BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.34 (1966, Supp. 1968); Pridemark v. Comm'r, 42 T.C. 510 (1964).

[37] INT. REV. CODE of 1954, §§ 331, 337; Pridemark v. Comm'r, 42 T.C. 510 (1964). Tax consequences flow from the determination whether a transaction is a reorganization or a liquidation, *see* Estate of Stauffer, 48 T.C. 277, *rev'd*, 403 F.2d 611 (9th Cir. 1968); BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 9.67 (1966, Supp. 1968).

[38] Since no assets would be transferred to the new corporation the transaction would be a § 331 liquidation, not a reincorporation.