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The Treatment of Contingent Consideration in Tax-Free Corporate Acquisitions

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The Treatment of Contingent Consideration in Tax-Free Corporate Acquisitions

*John André LeDuc**

This article reexamines existing limitations on the use of contingent consideration in tax-free corporate acquisitions. Analyzing the financial role of contingent consideration, it proposes new, less restrictive guidelines for the Internal Revenue Service, the courts, and practitioners. The article argues that these less restrictive rules accord with both the need to permit the reorganization of corporate enterprises and the current tax law which taxes sales of business enterprises.

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The Treatment of Contingent Consideration in Tax-Free Corporate Acquisitions

INTRODUCTION

THE USE of contingent consideration in corporate acquisitions has received scant scholarly attention from tax lawyers.[1] The lack of academic scrutiny belies the importance of the device and its theoretical interest in the tax law. Contingent consideration, the contractual provision for a flexible price term in corporate acquisitions, is the principal means employed to allocate and reduce risk and uncertainty in reorganizations.[2] The sources of contemporary apathy are several. The promulgation of relatively broad revenue procedures that allow affirmative rulings on use of contingent and escrowed stock,[3] revenue rulings that have upheld the use of sophisticated convertible stock,[4] and an accounting shift that has reduced interest in such sophisticated devices[5] have all combined to draw critical attention from the tax treatment of many forms of contingent consideration in acquisitive reorganizations. Despite the absence of contemporary attention, the law of contingent consideration is riddled with inconsistencies and out-

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1. Those commentators who have focused on the question have usually addressed only one aspect of the broader problem. For example, several commentators have analyzed the treatment of contingent and escrowed stock. *See* Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725 (1971); Murphy, *Contingent Share Reorganizations*, 1969 S. CAL. TAX INST. 255; Tillinghast, *Contingent Stock Pay-Outs in Tax-Free Reorganizations*, 22 TAX LAW. 467 (1969).

2. Although it is possible to distinguish between risk as the condition in which possible outcomes comprise a vector matrix, with a probability assigned to each possible outcome, and uncertainty as the condition in which the outcomes cannot be assigned a probability, that sophistication is unnecessary for the present task. Accordingly, risk and uncertainty will be employed interchangeably.

3. Rev. Proc. 77-37, 1977-2 C.B. 568.

4. *E.g.*, Rev. Rul. 73-205, 1973-1 C.B. 188 (voting, convertible stock with contingent conversion ratio).

5. For example, the requirement that earnings per share reflect potential dilution through conversions. *See* Accounting Principles Board, Opinion No. 14 (1969). Perhaps even more important are the limitations that have been placed on the use of pooling of interest accounting. *See* Accounting Principles Board, Opinion No. 16 (1970).

right contradictions.[6] The status quo is maintained only by administrative fiat and *sub rosa* resolution of the difficult theoretical issues. The purpose of this article is to highlight the doctrinal problems and propose new solutions.[7]

The sources of uncertainty in corporate acquisitions are many, but they may be roughly grouped in the following four types. First, the scale economies that the resulting combination will yield may be uncertain. When the size of the pie is itself uncertain, the allocation of shares must be uncertain, too. Second, if the consideration passed in the acquisition is of uncertain value, the parties may want to provide for a second look at the price of the acquisition. This is often the case if the acquisition involves stock without a market value. Third, the shareholders of the acquired corporation may be uncertain as to the future policies of the new management and seek the protection of an additional payout if the management adopts certain policies. Fourth, the parties may be uncertain as to the performance of warranties made in the exchange and provide for a variation in the price term of the acquisition as a form of liquidated damages. Any of these uncertainties may induce the parties to provide for contingent consideration in the acquisition.[8]

The sources of the doctrinal problems are two. The first is theoretical. The reorganization law premises a reorganization transaction. The paradigmatic case is a single event at which time the rights of the parties, including both corporations and their share-

6. Although serious doctrinal problems also exist in the treatment of divisive reorganizations, those problems will not be explicitly addressed here. *See, e.g.*, Gordon v. Commissioner, 424 F.2d 378 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970). There are two reasons for this exclusion. First, the need for contingent consideration in most divisive reorganizations is much less significant; thus there is less need to provide in the tax law for such devices to meet bona fide business needs. Second, many of the theoretical problems are the same. The analysis developed here in the context of acquisitive reorganizations can, in many cases, be applied to divisive reorganizations as well.

7. Because of the task of this article, some basic familiarity must be presumed with subchapter C of the Internal Revenue Code (and the reorganization provisions thereof in particular) and with corporate finance. No attempt will be made here to define the basic financial instruments or the basic reorganization tax concepts.

8. The parties may attempt to allocate and reduce risk with devices other than contingent consideration. For example, they may provide for indemnification or for arbitration. In some sense, such rights will constitute contingent consideration. Similarly, backout rights on certain events may be characterized as contingent consideration. *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 14.56 (3d ed. 1971). For the purposes of this article, however, "contingent consideration" will designate only those devices employed when no price term is fixed; all the above devices presume a fixed price term and provide for modification if that term proves unhappy.

holders, are rearranged. In the case of a reorganization in which uncertainty requires the use of contingent consideration, no such discrete transaction occurs. Instead, the exchange takes place within the context of a contractual relationship with the ultimate interests determined only after the passage of time. The theoretical problem, then, is how to cope with an ongoing exchange relationship in a statute structured for discrete exchange transactions.[9] It is this theoretical problem which has underlain the more apparent practical problems of contingent consideration.

The second source of difficulty has been the emergence of two separate and inconsistent lines of authorities. The first follows *Helvering v. Southwest Consolidated Corp.*[10] and prohibits contingent consideration in an apparent attempt to accord only exchange transactions nonrecognition under reorganization law. The second follows *Carlberg v. United States.*[11] That case permits the introduction of contingent consideration in the form of contingent stock. While the opinion draws some principles from *Southwest Consolidated,* it is generally more sympathetic to the need to reduce uncertainty in these transactions. Although these two lines of authority appear inconsistent, that inconsistency has not been remarked in the literature.[12] Part of the task of this article is to make out the claim that the contradiction is real.[13]

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9. For a discussion of this distinction, see I. MACNEIL, CONTRACTS 68-72 (1969).

10. 315 U.S. 194 (1942).

11. 281 F.2d 507 (8th Cir. 1960).

12. Most courts and commentators seem to assume that the law of contingent consideration, while arcane and highly formal, is fundamentally consistent. *E.g.*, Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960); Gordon v. Commissioner, 51 T.C. 1032 (1969), *aff'd*, 424 F.2d 378 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970); B. BITTKER & J. EUSTICE, *supra* note 8, ¶¶ 14.31, .56.

13. It is important at the outset to note the limits of this project. The current law of the taxation of stock warrants and contingent consideration is well developed and complex. The attempt here is only to analyze the problem as a subchapter C problem. Two problem areas would become of special interest if the reforms proposed herein were to become effective. The first is the proper scope of I.R.C. § 483 with regard to contingent consideration. The Internal Revenue Service takes the position that contingent consideration is taxable as ordinary income under § 483. Treas. Reg. § 1.483-1(b)(6), example (7), T.D. 6873, 1966-1 C.B. 101, 106 (contingent stock); *accord*, Rev. Rul. 73-298, 1973-2 C.B. 173; Rev. Rul. 72-35, 1972-1 C.B. 139 (§ 483 applicable to contingent stock payout in B reorganization); Rev. Rul. 72-32, 1972-1 C.B. 48 (§ 483 applicable to contingent stock payout in A reorganization); Rev. Rul. 70-300, 1970-1 C.B. 125. *But see* Treas. Reg. § 1.483-1(b)(6), Example (8), T.D. 6873, 1966-1 C.B. 101 (§ 483 not applicable to contingent consideration paid through escrow arrangement); *accord*, Rev. Rul. 70-120, 1970-1 C.B. 124 (escrowed stock not subject to § 483).

The courts have only recently reached the question of the applicability of § 483 to contingent consideration in reorganizations and have consistently held that the provision is applicable and the Commissioner's regulations are valid. Solomon v. Commissioner, 67

The first stage establishes the existence of two inconsistent lines of authorities, that following *Southwest Consolidated* and that following *Carlberg*. Second, the fundamental theoretical problems are analyzed. On the basis of the general, theoretical analysis, new rules are proposed for the application of the nonrecognition and basis provisions. Fourth, the possible tax avoidance opportunities—seemingly important in the Service's view[14]—are critically examined. The article then examines the law as it exists today for the practicing lawyer and how this analysis can offer some avenues for safely exceeding the current ruling guidelines on contingent consideration. A conclusion points out the need for, and the availability of, reform.

I. Two Lines of Authorities in the Taxation of Contingent Consideration

A. *The* Southwest Consolidated *Line*

The first line of authorities for the taxation of contingent consideration is the dominant one.[15] Derived from the principal authority of *Southwest Consolidated*,[16] this line has informed the decisions of the lower courts[17] and the Service.[18] The issue in

T.C. 379, 385-86 (1976), *aff'd*, 570 F.2d 28 (2d Cir. 1977) (§ 483 applicable to a contingent stock payout in a B reorganization); Jeffers v. United States, 556 F.2d 986, 993-97 (Ct. Cl. 1977) (contingent stock payout in A reorganization subject to § 483; Treas. Reg. § 1.483-1(b) upheld); Catterall v. Commissioner, 68 T.C. 413, 419-22 (1977) (§ 483 held applicable and the regulations under I.R.C. § 483 upheld in the case of a B reorganization). *See also* Cocker v. Commissioner, 68 T.C. 544, 560-61 (1977).

Prior to a resolution of the matter in the courts, there was much discussion of the provisions, much of it critical, in the secondary literature. *E.g.*, Berger & Kanter, *Does Imputed Interest Rule Apply to Reorganizations?*, 39 J. TAX. 127 (1973); Berger & Kanter, *Problems in Computing Interest on Contingent Payments*, 23 J. TAX. 191 (1965); Clark & Kascle, *Proposed Imputed Interest Regulations: A Critique of the Non-Routine Areas*, 23 J. TAX. 66 (1965).

The second problem is the proper treatment of warrant lapse. Current law requires the corporation issuing warrants to recognize gain on their lapse. Rev. Rul. 72-198, 1972-1 C.B. 223 (modified as nonretroactive, Rev. Rul. 77- 40, 1977-1 C.B. 248; further modified by Rev. Rul. 78-73, 1978-9 I.R.B. 18). If either of those positions is correct—and both are extremely problematic, as a matter of theory—they significantly affect the use of contingent consideration in reorganization. Those complex problems are not within the scope of this article.

14. *See, e.g.*, Rev. Proc. 66 -34, 1966 -2 C.B. 1232.

15. The broad application of this line is probably attributable in part to its source in the Supreme Court and in part to the expansive language of the *Southwest Consolidated* opinion. *See, e.g.*, B. BITTKER, & J. EUSTICE, *supra* note 8, ¶ 14.31, at 14-76 to 79.

16. 315 U.S. 194 (1942).

17. *E.g.*, Gordon v. Commissioner, 424 F.2d 378 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970); William H. Bateman, 40 T.C. 408 (1963), *appeal dismissed*, (4th Cir. Jan. 28, 1964). *But see* Clark v. Commissioner, 162 F.2d 677 (8th Cir. 1947) (warrants for debentures permitted in an insolvency exchange).

18. *E.g.*, Treas. Reg. § 1.354 -1(e) (1955). *See* B. BITTKER & J. EUSTICE, *supra* note

Southwest Consolidated was whether voting stock warrants could be received in a tax-free reorganization under the predecessor to section 368(a)(1)(B).[19] The Court, per Justice Douglas, held that nonrecognition treatment was unavailable for any of the gain realized under the exchange because the transaction did not qualify as a reorganization. Justice Douglas reasoned that the voting stock requirement of the statute was absolute. " 'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement. . . . [T]he acquisition in this case was not made 'solely' for voting stock."[20] The opinion thus emphasizes the "plain meaning" of the statute. Justice Douglas remarked three reasons why voting stock warrants were not themselves voting stock.[21] First, the rights of the warrant holder were purely contractual. Second, correspondingly, the warrant holder acquired no property rights in the underlying shares or in the assets of the corporation. Third, the remedy for the violation of the warrant holder's rights lay in money damages; under no circumstances could he compel the delivery of the shares.[22]

The argument may be formalized as follows: (1) the statute requires that only voting stock be given in a B reorganization as consideration for control of the acquired corporation; (2) voting stock warrants are not voting stock; (3) therefore this is not a B reorganization. This reasoning requires the answers to two questions. First, what are the rights of the parties immediately after the exchange? Second, are those rights identical to those which are allowed to be exchanged?[23] If those rights do not match exactly in a potential B or C reorganization, then deny reorganization status to the entire transaction. Thus does the approach look at the form of the transaction rather than the substantive rights of

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8, ¶ 14.31, at 14–75. *But see* Pressed Steel Car Co., 3 T.C.M. (CCH) 868 (1944), *aff'd per curiam*, 152 F.2d 280 (7th Cir.), *cert. denied*, 328 U.S. 838 (1946), in which it was the Service that argued warrants could be received in a nonrecognition exchange under the reorganization provisions.

19. 315 U.S. 194, 196 (1942). The predecessor statute is reproduced in *id.* at 196.

20. *Id.* at 198–201.

21. *Id.* at 200–01.

22. *Id.*

23. Although there is no explicit requirement in the opinion that the bundle of rights received be identical to the ordinary rights constituting stock or voting stock, such a requirement is consistent with the tenor of the opinion. *See id.* at 200–01.

the parties and follow the statutory language rather than the statutory purpose. Justice Douglas stated baldly:

> [I]t makes no difference that, in the long run, the unexercised warrants expired and nothing but voting stock was outstanding. The critical time is the date of the exchange. In that posture of the case, it is no different than if other convertible securities had been issued, all of which had been converted within the conversion period.[24]

Such an analysis never raises the following questions. First, does the exclusivity requirement apply to all consideration or only to property? Second, when are the tax consequences properly determined? Third, when is an exchange complete? Justice Douglas' opinion presupposes that exclusivity applies to all consideration, that tax consequences are determined immediately, and that an exchange is complete when the initial exchange is complete. These premises, however, are not supported by argument.[25]

There are two possible interpretations of this opinion. Both begin with the premise that the formal model is, on its face, a complete model for the treatment of contingent consideration in

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24. 315 U.S. at 201.

25. The gaps in Justice Douglas' opinion can be explained on either of two theories. The first suggests that Justice Douglas was all too frequently willing to decide tax cases based solely on his subjective preferences. The failure to support the reasoning regarding warrants in *Southwest Consolidated* would seem to be only one more example. B. Wolfman, J. Silver & M. Silver, Dissent Without Opinion 131–35 (1975). The second would emphasize the similarity between the issue presented in *Southwest Consolidated* and issues presented to the Court in Consolidated Rock Prods. v. DuBois, 312 U.S. 510 (1941). In that case, some commentators have suggested that Justice Douglas, a former SEC chairman, took the opportunity of a case involving an insolvency reorganization to warn the investment community of the hazards of stock warrants. If Justice Douglas were so concerned at that time with the hazards of stock warrants, he may well have acted to reduce the use of such instruments in tax-free reorganizations by imposing the heavy tax burden resulting from the *Southwest Consolidated* decision.

But *Southwest Consolidated* is understood today as offering authority not only for the holding that stock warrants will not qualify as stock, Gordon v. Commissioner, 424 F.2d 378, 382–83 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970); William H. Bateman, 40 T.C. 408, 414–15 (1963), *appeal dismissed*, (4th Cir. Jan. 28, 1964), but also for the proposition that stock warrants will not qualify as securities, Treas. Reg. § 1.354–1(e) (1955). *See* B. Bittker & J. Eustice, *supra* note 8, ¶ 14.31, at 14–75. Originally, the opinion was not read nearly so broadly. Even before *Southwest Consolidated* the Board of Tax Appeals in E.P. Raymond, 37 B.T.A. 423 (1938), had held under a predecessor statute that warrants would qualify for nonrecognition. After the Supreme Court opinion, however, there remained some uncertainty regarding the scope of the decision. For example, the Service argued that in the context of an insolvency reorganization warrants were permitted. Pressed Steel Car Co., 3 T.C.M. (CCH) 868 (1944), *aff'd per curiam*, 152 F.2d 280 (7th Cir.), *cert. denied*, 328 U.S. 838 (1946). The Eighth Circuit, in an insolvency reorganization, held that warrants received by debenture holders were entitled to nonrecognition of gain or loss. Clark v. Commissioner, 162 F.2d 677 (8th Cir. 1947). Thus, it would seem, *Southwest Consolidated* was initially read far more narrowly than it is today.

corporate reorganizations.[26] The first interpretation would construe the holding in *Southwest Consolidated* that the statutory language leaves no leeway in its specification of permissible consideration to limit consideration to those rights which most fundamentally constitute "voting stock." Under this view any right of conversion, because it does not inhere in the concept of voting stock, would constitute impermissible consideration and disqualify a potential B reorganization. In a statutory merger or consolidation, by contrast, the presence of such a right would constitute boot.[27] Thus on this reading of *Southwest Consolidated*, because the classes of consideration entitled to nonrecognition are fundamentally classes of interests comprised of fixed rights, all contingent consideration comprised of time variant[28] rights would be disqualified.[29]

A more limited reading of *Southwest Consolidated* would exclude only those interests separate from, rather than appurtenant to, qualifying interests. In the case of qualifying stock, a conversion privilege would not constitute boot because it would be appurtenant to the qualifying interest.[30] By contrast, an otherwise qualifying stock interest coupled with a separately negotiable stock warrant would fail to qualify.[31] On this interpretation of *Southwest Consolidated*, although some forms of contingent consideration would be permitted, no forms which were not parasitic upon qualifying interests would qualify. In particular, contingent stock, escrowed stock, and stock warrants would all seem to fail to qualify.[32] It is unnecessary to choose between these two interpretations of the opinion because the task here is simply to describe the present law. Whichever interpretation is more nearly accurate, both interpretations agree that the *Southwest Consolidated*

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26. Technically, of course, the holding in *Southwest Consolidated* goes only to the qualification of stock warrants as voting stock in a B reorganization; the holding is only one of multiple grounds of decision. *See* 315 U.S. at 199-201.

27. Whether the conversion right would disqualify the stock interest from nonrecognition entirely or whether the boot would be valued solely with regard to the value of the right of conversion itself is an open question.

28. That is, simply, the rights will vary over time as the contingencies are or are not realized.

29. Whether such disqualification would cause all or only a portion of the gain to be recognized would depend upon the statutory context.

30. *See* Rev. Rul. 75-33, 1975-1 C.B. 115 (contingent dividend rights not boot because inherent in qualifying stock interest); Rev. Rul. 73-205, 1973-1 C.B. 188 (convertible preferred with floating conversion ratio).

31. *See* Rev. Rul. 70-108, 1970-1 C.B. 78.

32. This, of course, is not the law in that by administrative action the Service has permitted in limited measure contingent and escrowed stock.

opinion,[33] written as it is in general terms, provides a comprehensive scheme for contingent consideration.

Representative of the judicial authorities which follow *Southwest Consolidated* are *William H. Bateman*[34] and *Gordon v. Commissioner.*[35] In *Bateman*, stock warrants were transferred to the shareholders of a nonsurviving corporation in a merger. Since the transaction qualified as a reorganization under section 368(a)(1)(A) of the Code, the issue before the court was whether the warrants were stock for the purposes of section 354(a)(1).[36] Citing *Southwest Consolidated*, the court held that stock warrants were not stock and therefore not entitled to nonrecognition.[37] In *Gordon*, the issue before the court was whether, in a D reorganization, warrants qualified as "stock or securities."[38] Citing *Southwest Consolidated*, the court held that the warrants were not stock.[39] The court refused to reach the question whether such warrants constituted securities on the argument that, even if securities, the receipt would be taxable on the peculiar facts of this exchange.[40] Thus the holding in *Southwest Consolidated* has been extended judicially to reach stock warrants in A and D reorganizations.

More important, the Service has construed *Southwest Consolidated* broadly. The first important Service interpretation of the *Southwest Consolidated* decision came in its 1955 regulations interpreting sections 351, 354, and 355.[41] The Service held that stock options and warrants would qualify neither as stock nor as securities for the purposes of those provisions. Thus the holding of *Southwest Consolidated* that voting stock warrants did not qualify as voting stock in section 368(a)(1)(B) was enormously extended in scope. The Service has since consistently applied the provision broadly. In Revenue Ruling 57-586,[42] the Service ruled that the receipt of the *Carlberg* certificates of contingent interest in a statutory merger would not be entitled to nonrecognition of in-

33. 315 U.S. 194 (1942).
34. 40 T.C. 408 (1963).
35. 424 F.2d 378 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970).
36. 40 T.C. at 408.
37. *Id.* at 415.
38. 424 F.2d at 381.
39. *Id.* at 382.
40. *Id.*
41. Treas. Reg. §§ 1.351-1(a)(1), T.D. 6942, 1969-1 C.B. 136; 354-1(e); .355-1(a).
42. 1957-2 C.B. 249.

come. That decision was overruled by the Eighth Circuit in *Carlberg*, but the Service continues to hold a restrictive interpretation of the permissible place of contingent consideration in reorganizations. In Revenue Ruling 70–108,[43] the Service ruled that convertible preferred stock which entitled its holder to acquire an additional share on conversion for a cash payment (in effect, an attached warrant) did not constitute voting stock. The citation, again, was to *Southwest Consolidated*.[44] Most recently, the Service ruled in Revenue Ruling 78–408[45] that warrants could not be exchanged tax-free for outstanding warrants in a reorganization. Thus the Service has repeatedly applied *Southwest Consolidated* to prohibit contingent consideration in diverse types of reorganizations. The claim of *Southwest Consolidated* to hegemony in the theory of contingent consideration was challenged, however, by the *Carlberg* decision.

B. *The* Carlberg *Line*

There is no comparable statement of a functional interpretation of contingent consideration; this is in part probably due to the commanding position of *Southwest Consolidated* as a statement of the formal law.[46] Nevertheless, a functional approach is clearly embodied in the revenue procedure outlining the Service ruling policy on contingent stock[47] and in an opinion by Justice (then Judge) Blackmun on contingent stock.[48] In Revenue Procedure 77–37, the Service issued its current guidelines for the treatment of contingent stock.[49] That guide allows the use of contingent stock in all types of reorganizations[50] subject to certain limits relating to the relative magnitude of the use.[51] Those limitations are con-

43. 1970–1 C.B. 78.

44. *Id.* at 79.

45. 1978–47 I.R.B. 11.

46. *See* notes 15–25 *supra* and accompanying text.

47. Rev. Proc. 77–37, 1977–2 C.B. 568.

48. Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960).

49. 1977–2 C.B. 568. The first procedure guideline was issued as Rev. Proc. 66–34, 1966–2 C.B. 1232.

50. That procedure makes no distinction between qualifying contingent stock as voting stock and qualifying contingent stock simply as stock. Rev. Proc. 77–37, 1977–2 C.B. 568.

51. Those restrictions are (1) all stock must be issued within five years of the initial exchange; (2) there must be a valid business reason for the arrangement; (3) the maximum number of shares must be stated; (4) the interest in the contingent shares must in fact be nonnegotiable; (5) the shares ultimately to be received must be qualifying; and (6) 50% of the total share must be issued at the outset. *Id.*

cerned both with maintaining the substance of the transaction as a tax-free reorganization and barring the use of contingent consideration as a tax avoidance tool.[52] Although Congress probably did not envision the use of contingent consideration when it enacted the reorganization provisions,[53] the Service sought to construe the statute with regard to the general purpose, the financial realities of reorganization exchanges, and the appeal of horizontal equity. Thus the guidelines treat reorganizations under uncertainty like reorganizations without uncertainty.[54] Where the procedure departs from a functional interpretation of the statute is in its failure to take account of the statutory scheme and its failure to consider the propriety of the brightline rules it adopts.[55]

The second representative of the functional approach is the opinion in *Carlberg v. United States*.[56] The contingent consideration presented was contingent stock.[57] At issue was whether such an interest was boot or stock. The government argued that *Southwest Consolidated* controlled.[58] As a matter of interpretation, the government was probably right.[59] But while following the formal model in some important respects, the court deviated sufficiently from it to reach a contrary result.[60] Writing for the court, Justice

52. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.56; Murphy, *supra* note 1; Tillinghast, *supra* note 1.

53. No mention is made of the possibility in the committee reports for the 1934 Revenue Act, which enacted the voting stock restriction for what are now B and C reorganizations, nor in the revision of what is now § 354 in the 1954 Code. *E.g.*, H.R. REP. No. 704, 73d Cong., 2d Sess. 12-15 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 16-17 (1934); H.R. REP. No. 1337, 83d Cong., 2d Sess. 39-41, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4064-66. Nor is there any discussion of the problem in the secondary literature that suggests that Congress ever directly considered the problem.

54. The Service ignores in this context the objection, found telling against the receipt of warrants, that the receipt of an interest that itself is nonqualifying (like contingent stock) is not legitimized by the fact that the interest initially received is a dynamic interest and will either be transformed into a qualifying interest or will lapse. Instead, the Service simply glossed over this objection. Rev. Proc. 77-37, 1977-2 C.B. 568.

55. Thus it would seem that if contingent stock qualified, there would be no support for arbitrary limits that require that 50% of all stock be initially issued or that all stock be issued within five years.

56. 281 F.2d 507 (8th Cir. 1960).

57. The contingent stock was evidenced by negotiable "Certificates of Contingent Interest." *Id.* at 510.

58. 315 U.S. 194 (1942).

59. For an analysis of the *Southwest Consolidated* line of authorities, see notes 26-33 *supra* and accompanying text.

60. Justice Blackmun followed the formal model of *Southwest Consolidated* both in holding that the rights of the parties immediately after the exchange determined the tax consequences and in relying on highly formal (and seemingly trivial) differences in the instruments. One principal difference Justice Blackmun relied upon was that a warrant

Blackmun followed the earlier Supreme Court decision in holding both that the time of the exchange determined its tax consequences and that such an exchange would be deemed to occur on the first transfer of rights: "Certain other principles merit mention. The situation at the time of the merger and not that as of any later date is controlling or, as the Supreme Court has said, 'The critical time is the date of the exchange.' "[61]

Justice Blackmun departed from precedent by looking to the statutory purpose and to the substance of the rights:

> We also feel that the merger agreement and the provisions of the Certificates are properly interpreted and analyzed not alone within the limitations of their language (possible conflicting results as to which are well illustrated by the arguments of the opposing litigants here) but in the light of other and deeper considerations, namely, purpose, practicality, precedent and substance.[62]

In particular, Justice Blackmun noted the place of substance of the transaction in determining tax consequences:

> It has often been said in tax arguments, and occasionally decided, see Gregory v. Helvering . . .; Commissioner v. Court Holding Co. . .; Kanawha Gas & Utilities Co. v. Commissioner . . .; that substance must prevail over form. If this observation has any independent legal force or merit in the determination of tax causes, it compels a conclusion that the substance of the Certificates equates only with stock . . . . The rule of substance over form, therefore, this time operates in the taxpayer's favor.[63]

In so doing, he held that contingent stock qualified as stock.[64] Thus the *Carlberg* decision adopted a functional approach by looking to the substance of the transaction, taking note of the equities, and considering the statutory purpose.

Justice Blackmun, compelled to follow *Southwest Consolidated*[65] if it controlled, attempted to distinguish it.[66] It appears that the two cases are indeed inconsistent, notwithstanding

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gives its holder a right that he must affirmatively exercise, whereas a contingent stock right operates automatically. Careful drafting can overcome that difference, however, so it is difficult to understand why such a difference should play an important role in determining tax consequences.

61. 281 F.2d at 514 (citation omitted). In important respects, such as the timing of the determination of tax consequences, Justice Blackmun may well have felt bound by Supreme Court precedent.

62. *Id.* at 518.

63. *Id.* at 519-20 (citations omitted).

64. *Id.* at 520.

65. 315 U.S. 194 (1942).

66. 281 F.2d at 516-17.

the attempt to distinguish.[67] *Southwest Consolidated* excludes virtually all contingent consideration. Moreover, subsequent cases have confirmed the inconsistency. The courts have repeatedly been confronted with the government analogizing to *Southwest Consolidated* and the taxpayer analogizing to *Carlberg*.[68] Representative of these cases is *James C. Hamrick*.[69] There, in the context of a section 351 nonrecognition claim, the instrument at issue was a contractual right to receive additional shares for property contributed to a controlled corporation.[70] The Tax Court sided with the taxpayers, noting the "obvious differences" between such instrumental rights and the warrants of *Southwest Consolidated*.[71] Like the *Carlberg* court, the Tax Court emphasized the requirement that the shareholder act affirmatively and the positive exercise price for the warrants but, like the earlier court, could not explain why those distinctions ought to make a difference. The only option available was to proceed by analogy, with the closer analogy governing the case. In *Hamrick*, the court concluded that the contingent interest was more akin to that permitted in *Carlberg* than to that barred by *Southwest Consolidated*.

Of the subsequent authorities in the *Carlberg* line, the Service treatment of contingent and escrowed stock[72] has been described above. The *Hamrick* case,[73] which follows *Carlberg* in its analysis of contingent consideration, has also been presented. These constitute the principal authorities in the *Carlberg* line. Also important, if less direct progeny of *Carlberg*, are the revenue rulings that permit convertible stock. Revenue Ruling 73-205[74] described a B reorganization that provided for contingent consideration in the form of a floating conversion ratio for voting convertible preferred stock. The Service, citing the ruling that approved the *Hamrick*

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67. *See* notes 26–33 *supra* and accompanying text.

68. *E.g.*, Gordon v. Commissioner, 424 F.2d 378, 381, 382 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970); James C. Hamrick, 43 T.C. 21 (1964), *vacated and remanded per stipulation*, 1966–1 U.S. Tax Cas. ¶ 9322. The status of *Hamrick* is seemingly problematic. Although the Tax Court decision was vacated and remanded by the court of appeals pursuant to agreement of the parties, the Service subsequently acquiesced in the decision. While *Hamrick* is technically not good authority for any proposition, it is regularly cited as authority, *e.g.*, Jeffers v. United States, 556 F.2d 986 (Ct. Cl. 1977), and does represent the Service position. *See* Rev. Rul. 66-112, 1966–2 C.B. 68.

69. 43 T.C. 21 (1964).

70. *Id.* at 33.

71. *Id.*

72. Rev. Proc. 77-37, 1977-2 C.B. 568.

73. 43 T.C. 21 (1964).

74. 1973-1 C.B. 188.

result,[75] held that such contingent consideration was qualified and did not bar reorganization status.[76] *Southwest Consolidated* was conveniently ignored. In general, then, *Carlberg* has governed contingent and escrowed stock and convertible preferred stock. *Southwest Consolidated* has governed stock options and warrants even when those rights are attached to otherwise qualifying instruments.[77]

C. *Uncertainty and the Possibility of Reform*

There are three principal sources of uncertainty in the current treatment of contingent consideration in tax-free reorganizations. First, little regard is paid to the statutory scheme which divides consideration into voting stock, stock, and securities[78] for the purpose of determining tax consequences. For example, the Service ruling guidelines on contingent stock make no distinction between qualifying such contingent stock in an A or B reorganization.[79] Second, there is clear inconsistency among many of the Service positions on the use of contingent consideration and the decisions of the courts. At least arguably, none of the contingent consideration payouts that have been permitted by the courts would qualify for an advance ruling from the Service.[80] Third, because of the inconsistent paradigms for the treatment of contingent consideration and the two lines of authorities in which they are embodied, a new instrument must be of uncertain tax status. Which paradigm will be applied and which analogy between stock warrants and contingent stock will be found controlling is not always obvious.[81]

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75. Rev. Rul. 66-112, 1966-1 C.B. 68.

76. Rev. Rul. 73-205, 1973-1 C.B. 188, 189.

77. The treatment of convertible preferred stock has also been governed by *Carlberg*, even if issued in a putative B reorganization. *See, e.g.*, Rev. Rul. 73-205, 1973-1 C.B. 188.

78. The relationship between the term "stock" and the term "securities" is by no means perspicuous. Thus one interpretation has been that the term "stock and securities" ought to be construed as a single term. But whether that approach be adopted, it should be noted that "securities" does not ordinarily include within its scope "stock," in the Internal Revenue Code.

79. If it seems that such a distinction would be unduly academic, consider that on the crucial issue of voting rights, contingent stock does not carry voting rights. This would surely seem to make a very real difference in the measure of voting stock and other stock.

80. The exchange in McAbee v. Commissioner, 5 T.C. 1130, 1132-42 (1945), would have violated the 50% rule and the nonnegotiability rule. The *Carlberg* deal violated the five-year rule, the stated maximum rule, the 50% rule, and the nonnegotiability rule. 281 F.2d at 511-13. The *Hamrick* transaction violated the five-year rule and the nonnegotiability rule. 43 T.C. at 22-31.

81. *E.g.*, Gordon v. Commissioner, 424 F.2d 378 (2d Cir.), *cert. denied*, 400 U.S. 848 (1970) (litigation to determine whether warrants failed to qualify as "stock or securities").

These three factors combine to produce significant uncertainty in the treatment of contingent consideration in reorganizations.

The uncertainty of the current law, then, is one of the pragmatic criticisms that may be made of the current treatment of contingent consideration. But the problems run deeper than the uncertainty that survives the third of a century since *Southwest Consolidated*. The present doctrine itself is open to criticism. First, the presence of the two, inconsistent lines of authorities evidences the incoherence of the contemporary treatment. Any reform of the current law must make a serious attempt to restore consistency. Second, as indicated above, the contemporary law takes little account of the statutory trichotomy for consideration (voting stock, stock, and securities) in reorganization. Greater fidelity to law is required in this respect. Third, and probably most important, is the failure to realize the broad statutory policy favoring the tax-free reorganization of corporate enterprises. As noted in the introduction, the arbitrariness of the current law has hampered many exchanges simply because of the uncertainty confronting the parties attempting to negotiate a corporate acquisition. Reform of the current law must seek a greater fidelity to the statutory purpose.

II. The Theory of the Taxation of Contingent Consideration

The potential use of contingent consideration in tax-free corporate acquisitions poses three fundamental problems. The first problem created by contingent consideration is that of determining when the tax consequences of a reorganization exchange are derived. Although the problems are not entirely novel, they are raised in a peculiarly acute form by contingent consideration. When a transaction is deemed closed for the purpose of tax determinations is, after all, the problem which the step transaction doctrine attempts to resolve.[82] That doctrine discounts the discreteness of the form in which a series of transactions is cast to determine tax consequences only with respect to the parties' final posture.[83] While the limits of that doctrine are by no means

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82. *See generally* American Bantam Car Co., 11 T.C. 397, 405–08 (1948), *aff'd*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

83. The consolidation is generally urged when, as in *American Bantam*, the taxpayer can derive more attractive tax results by treating certain stages in a single business plan as separate for application of the nonrecognition provisions. *See* 11 T.C. at 405–08.

clear,[84] the puzzles created by contingent consideration, with its time variant rights, are of another order of magnitude. For each transaction in which contingent consideration is employed, the parties have not only the actual rights they hold at the completion of the initial exchange, but a set of potential rights which may or may not qualify as property,[85] and a set of potential future rights. When tax consequences are determined may well decide the tax status of a transaction.

The second problem is that of determining the bundle of rights which is examined to determine tax consequences. Because contingent consideration gives its holder time variant rights,[86] this problem is not so simple as with ordinary forms of consideration. In the formal model it is the rights held immediately after the exchange that determine the tax consequences;[87] in the functional model (at least arguably) it is the rights held after the substantial completion of the exchange.[88] In the current blackletter law, this means that steps that are deemed to occur automatically (*e.g.*, the issuance of additional contingent stock) are considered part of the exchange, while contingent consideration vesting the right of exercise in the holder is deemed to carry additional rights beyond those received in the exchange.[89]

To solve the puzzle of which bundle of rights is properly isolated to determine tax consequences in a statute premised upon exchange transactions rather than exchange relationships[90] requires a close analysis of the statutory purpose. It must be deter-

84. For a survey of some of the problems remaining, see Hobbett, *The Step Transaction Doctrine and Its Effect on Corporate Transactions*, 19 TUL. TAX INST. 102, 123–38 (1970); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. FED. TAX. 247 (1954) (1939 Code).

85. In some open transactions, the rights will only be contractual, as, for example, the right to reserved shares.

86. *See* note 28 *supra*.

87. *See* Helvering v. Southwest Consol. Corp., 315 U.S. 194, 201 (1942).

88. *See, e.g.*, Rev. Proc. 77-37, 1977-2 C.B. 568.

89. *See* Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960).

90. *See* note 9 *supra*. The problem of the adequacy of the statute to deal with reorganizations under uncertainty is a theme that runs throughout this article and is explicitly addressed in the conclusion. The courts, by their willingness to adopt the restrictive Service interpretations and their plaintive appeal to the "plain meaning" of the statute, are either indifferent to the plight of these taxpayers or convinced that the current statute is unable to handle these problems and that Congress must provide the solutions by amendment. While amendment would indeed be a simple means by which to resolve these problems, it also seems possible to effect reform at the judicial and administrative levels. In this sense, it will be urged that although the legislators did not explicitly address the problems of contingent consideration, this statute, construed by careful courts, can handle these problems.

mined whether the various restrictions on consideration in reorganizations exclude only interests that are substantially different from qualifying interests or whether the restrictions exclude interests which differ at all.[91] If the former construction be correct, then a convertible debt instrument which embodies substantially an equity interest ought to qualify as stock; if the latter construction be correct, then the interest would fail to qualify as stock.[92]

The third theoretical question that has arisen for contingent consideration is the importance of the traditional distinction between property and contract. At first impression the distinction seems irrelevant. But the Service has emphasized the distinction by proposing to rule affirmatively on contingent consideration which is nonnegotiable while indicating that it will deny such rulings for negotiable interests.[93] This distinction is apparently founded on the distinction of *Carlberg* that a contingent right to receive additional shares of stock, a contract right, is different from a stock warrant, a property interest.[94] Developing this unarticulated doctrine and evaluating the importance of the distinction in this context is the third task here.

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91. Surprisingly, this fundamental question has not been asked by the courts or by the commentators. *See, e.g.*, Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960); Dailey, *supra* note 1.

92. The possibility of a substantial equivalence test is reinforced by the adoption by accountants of the concept of equity equivalents in the treatment of hybrid instruments. Accounting Principles Board, Opinion No. 14 (1969). The possibility of establishing a concept for the tax law of substantial equity equivalence has also been suggested by the Special Committee on Reorganizations of the Tax Section of the New York State Bar. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.31, at 14–73.

Although the current law is clear in its resolution of this problem, that resolution has not been defended. *See* Rev. Rul. 69–91, 1969–1 C.B. 106 (convertible debentures disqualify a transaction as a B reorganization).

93. Rev. Proc. 77–37, 1977–2 C.B. 568.

94. The language of the statute states that the exchange must be solely for voting stock. What the statute does not explicitly provide is whether stock control (or the assets in a C reorganization) must be acquired solely in consideration for voting stock or solely in a property exchange for voting stock. The crucial difference is that the former would exclude all forms of consideration other than voting stock; the latter would seemingly exclude only other forms of property. The difference, then, would be the treatment of bare contractual rights. Insofar as certain forms of consideration are simply contractual rights, and not property, how this section is interpreted will have an important effect on the delineation of the scope of stock and assets acquisitions. The Service, of course, firmly takes the position that the restriction in § 368 runs to all bargained-for forms of consideration, not just property, and has established that position in some courts. *E.g.*, Mills v. Commissioner, 331 F.2d 321 (5th Cir. 1964). *But see* Dailey, *supra* note 1, at 776–77.

A. *Timing the Determination of Tax Status*

Although the problems of when to determine the tax consequences of a putative reorganization exchange are by no means simple, by first resolving those questions it is possible to proceed to the even more troubling problems of defining how time variant rights ought be treated. The problem is most troubling because the theoretical issues are so unusual. In most exchange transactions which give rise to tax consequences, the transaction is discrete rather than continuous.[95] So the tax law relating to the treatment of such continuous, time variant rights is not well developed, and there remain basic theoretical puzzles. The threshold question for contingent consideration is whether such consideration has been realized as income by the exchanging shareholder.[96] Absent realization, there can be no question of whether the gain or loss ought to be recognized.

In select corporate acquisitions, there may be no realization of the contingent consideration by the recipients.[97] In those cases realization must await the arrival of the contingencies; until the claims mature, there is no income. But there is good reason to believe that the class of transactions which will be styled "open" in this sense is very limited. First, it is today recognized that the taxpayer whose income is reported under the open transaction doctrine receives a tax windfall.[98] Second, the Service has sought to restrict the scope of the doctrine.[99] Third, and perhaps most important, many forms of contingent consideration will fail to qualify for the application of the doctrine under the Service approach that has been upheld in the courts.[100] For that narrow

95. Of course, most taxable events probably occur within an ongoing exchange relationship. *See* I. MACNEIL, *supra* note 9, at 170–72. Nevertheless, such events are usually sufficiently discrete to be characterized as transactions. For a classic example of a taxable transaction in the context of an exchange relationship, see Commissioner v. Duberstein, 363 U.S. 278 (1960).

96. *See* M. CHIRELSTEIN, FEDERAL INCOME TAXATION 68–71 (1977). Whether the realization requirement is a mere administrative requirement or a constitutional restriction on the federal income tax power has been a matter of dispute. *Compare* Eisner v. Macomber, 252 U.S. 189, 207 (1920) *with* M. CHIRELSTEIN, *supra*, at 68–71. Professor Chirelstein's view that realization is a device to make the application of the income tax to appreciation in assets practicable, by requiring roughly that any increase in value be validated by an arm's-length transaction, is today more widely accepted. *Id.* at 68.

97. M. CHIRELSTEIN, *supra* note 96, at 243. I have found no cases or rulings in which the income has been reported in this manner.

98. *Id.* at 242.

99. Rev. Rul. 58-402, 1958-2 C.B. 15.

100. *See, e.g.*, Frizzelle Farms, Inc. v. Commissioner, 61 T.C. 737, 744 (1974), *aff'd per*

class of transactions that falls within its scope,[101] the taxpayer need report no gain until he has recovered his basis. This will almost never occur in the payment of contingent consideration, so the taxpayer will simply reduce his carryover basis in the otherwise qualifying reorganization exchange. If this doctrine solves the problem of when to determine the tax consequences of certain transactions—only upon a delayed realization—for the bulk of contingent consideration acquisitions, the threshold requirement of realization will be met. The problem then of when to determine recognition must be faced.

There are at least three potential choices. First is the standard of *Southwest Consolidated* which tests the interests immediately after the exchange. Any future rights then held disqualify either the transaction or the consideration received, depending upon the statutory context.[102] On this view it is the initial, not the final or any intermediate, rights which determine the tax consequences. Second is an approach like that of the step transaction doctrine which seeks to examine the intent of the parties and the function of the transaction to assess the economic and financial realities of a transaction or series of transactions to determine the tax consequences. Under this test an exchange with contingent consideration would be completed, at the latest, when the rights of the parties had reached what would remain substantially their final form. In the case of contingent stock, the transaction would be complete when the shareholder had received in the exchange substantially all the stock to which he was entitled. Of course, this test might be difficult to administer because the parties might have received substantially all the consideration that they would ultimately receive but remain unaware of that fact until the termination of the period for the issuance of contingent consideration. So long as there remained a possibility of significant additional rights for any party, the exchange would not be substantially com-

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curiam, 511 F.2d 109 (4th Cir. 1975) (fair market value of warrants held to be determinable).

101. For example, the transaction described in James C. Hamrick, 43 T.C. 21, 23 (1964), *vacated and remanded per stipulation*, 1966-1 U.S. Tax Cas. ¶ 9322, falls within that class. Stock and contingent rights to additional stock were received in exchange for untested patents in the organization of a corporation. *See also* M. CHIRELSTEIN, *supra* note 96, at 242.

102. Boot ordinarily disqualifies the entire transaction for a B reorganization or a C reorganization. *See* I.R.C. § 386(a)(1)(B), (a)(1)(C), (a)(2)(B). Boot is permitted, although taxed, in an A reorganization. *Id.* (a)(1)(A).

plete.[103] The third test for determining which interest defines tax consequences would examine the rights ultimately held by the parties after the final adjustments had been made. Under this approach, the presence of contingent consideration would be effectively ignored because tax consequences of the exchange would not be determined until all the contingent consideration had lapsed.[104]

The problem of determining when tax consequences are to be decided is principally a problem of the intended scope of the nonrecognition provisions. There are two possible interpretations of that scope. The first, more limited interpretation is that the general rule of recognition in the Code is paramount and that the statutory exceptions to that rule are to be read narrowly.[105] On that view, the absence of provision for a period during which tax determination may be suspended is dispositive.[106] The qualification for nonrecognition must be determined upon the realization of income. Absent qualification, the general mandate of recognition applies.[107] The second interpretation is that the paramount policy of recognition has been suspended in the case of reorganizations.[108] As the treasury regulations show, under this interpretation, the policy of nonrecognition is paramount[109] and the remedial provision of the nonrecognition provisions must be read broadly to effect the statutory relief intended. This view might be read either to require the suspension of determination until the substantial completion of the exchange or even until all revisions

103. *See* text accompanying notes 115-21 *infra*. A somewhat stricter version of this test would close the exchange when substantially all the property the parties would ultimately receive had been transferred. The difference, of course, is that such a test would ignore, for the purpose of determining tax consequences, the presence of contractual rights of conversion vested in the exchanging shareholder or escrowed stock held by the shareholders as beneficial owners. *See, e.g.*, Rev. Proc. 77-37, 1977-2 C.B. 568.

104. This approach has apparently not been adopted in any reported ruling or case. While it is possible (and helpful) to distinguish for our purposes between determining which interests are to qualify and when the determination is to be made, those two questions are indeed closely related and frequently indistinguishable in the opinions. *See, e.g.*, Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960).

105. *See, e.g.*, Hellerstein, *Mergers, Taxes and Realism*, 71 HARV. L. REV. 254, 264-65 (1957).

106. Thus nonrecognition of gain is appropriate for up to 18 months after the sale of a principal residence under I.R.C. § 1234 even if no replacement has yet been made because that period of contingent nonrecognition is provided under the statute.

107. I.R.C. § 1002.

108. The reorganization provisions are, on this argument, special provisions which override the general mandate of I.R.C. § 1002.

109. *See* Treas. Reg. § 1.1002-1(b), 1(c) (1960).

of interests are finally complete.[110]

Neither general position is free from doubt, but the stronger position seems to be that which urges that tax consequences are determined only upon the substantial completion of the exchange. The argument that nonrecognition is unavailable unless immediately available on realization of income seems open to three principal objections. First, the treasury regulations themselves seem to reverse the usual presumption in favor of recognition of income on corporate reorganization.[111] Second, to hold that the nonrecognition provisions must be read so narrowly seems inconsistent with the statutory intent to provide broad relief.[112] Third, although in other nonrecognition provisions Congress has provided *explicitly* that recognition be suspended pending a determination of qualification, given the strong statutory policy favoring nonrecognition of income on corporate reorganization, no statutory provision ought to be necessary to achieve the same result here.[113]

The argument for deferring the determination of tax consequences until the exchange is final and complete seems open to strong objection, too. First, such a rule would permit taxpayers to abuse the nonrecognition provisions by casting their transactions in a form as if they might finally qualify, with the intent only to postpone the tax. This would allow the taxpayer a significant tax deferral advantage. Second, the practical problems for such a suspension of tax determination would be insoluble. Accounting for the basis of interests disposed of in the interim, for example, could not be resolved. In short, to suspend the determination of the tax status of a transaction for perhaps five or more years[114] would be grossly impractical. The conclusion that a general determination of deferral cannot be adopted in reorganizations does not entail that a limited deferral rule, operative only if contingent consideration takes the form such that ultimate interests will be interests themselves initially permissible, may not be appropriate.

The best choice for the time at which to determine the tax consequences of a putative reorganization is the substantial comple-

110. The substantial completion of the exchange was apparently the test adopted in *Carlberg* when Justice Blackmun looked to what the parties had at the time the contingent stock lapsed.

111. Treas. Reg. § 1.1002-1(b), 1(c) (1960).

112. *See generally* Hellerstein, *supra* note 105, at 258-61.

113. *E.g.*, I.R.C. §§ 1233, 1234. For the argument to the opposite conclusion, see note 107 *supra*.

114. The *Carlberg* contingent stock payout, for example, exceeded five years in duration, as did the *Hamrick* exchange. *See* note 80 *supra*.

tion of the exchange. This rule accords with the step transaction doctrine, the remedial intent of Congress, the treasury regulations,[115] and the requirements of administration. Determination upon substantial completion accords with these other doctrines because it reduces the possibility of taxpayer manipulation of the incidence of taxation and taxes transactions according to their substance rather than their form. There are difficulties, of course.[116] Such a rule will require that certain exchanges remain open for a limited period, until they are substantially complete. It is probably within the power of the Service, in theory[117] and in fact,[118] to issue regulations which require the determination of tax consequences within a year or eighteen months after the initial exchange.[119] Such regulations would both serve the needs of administration and prevent the potential abuse of tax deferral. Of course, such a rule would conflict with the holding in *Southwest Consolidated*.[120] Insofar as that holding seems without support, inconsistent with the statute, and long eschewed by the courts and Service in the treatment of contingent and escrowed stock,[121] such conflict seems inescapable. Ordinarily contingent consideration would neither have yielded a final interest nor lapsed at the time the determination is made. If contingent consideration is to qualify in reorganizations, it must ordinarily do so by virtue of the qualification of the contingent interest.

B. *The Problem of Time Variant Rights*

The problem of taxing time variant rights—the paradigm of which is convertible securities—is a far more limited problem in

115. Treas. Reg. § 1.1002-1(b), 1(c) (1960).

116. For a discussion of the basis problems engendered by contingent consideration, see Section V *infra*.

117. *See* I.R.C. § 7805.

118. In practice, Service regulations have ordinarily withstood challenge in the courts. *See, e.g.*, United States v. Correll, 389 U.S. 299, 306–07 (1967).

119. A year would give the parties some flexibility in their transaction and is a natural period; the 18-month period is taken from the deferral period of I.R.C. § 1034 for the exchange of a principal residence. At present, the possible duration of exchange relations pursuant to a plan of reorganization is uncertain. In D.W. Douglas, 37 B.T.A. 1122, 1128 (1938), an exchange five years after the initial exchange was deemed to fall within the scope of the nonrecognition provisions; in W.N. Fry, 5 T.C. 1058 (1945), an exchange six years after the parties entered into a plan was held to qualify. But it would seem, nonetheless, that the Service has the power to restrict such indefinite duration by rule. Murphy, *supra* note 1, at 260–61.

120. 315 U.S. at 201.

121. Rev. Proc. 77-37, 1977-2 C.B. 568. For a review of the historical development of the analysis of *Southwest Consolidated*, see note 25 *supra*.

the law than that of deciding when to determine tax consequences.[122] But the problems, as Arthur Fleischer, Jr. and William L. Cary demonstrated,[123] are very difficult as a matter of tax theory. Just as they showed that no single theory of convertible securities could account for the tax law in that field,[124] so we have seen that the treatment of such time variant rights in reorganization exchanges is informed by inconsistent theories. But if the tax problems of convertibles are not generally to be solved by a single theory, there is a solution in the case of reorganizations. In order to realize the statutory purpose and to construe the current statutory language, it is necessary to read the terms of the statute with regard to their function. There is a broad policy requiring investors to keep their interest at risk after an exchange at least in the same measures as before the exchange.[125] If that policy is paramount, then a contingent interest that comprises an unqualified senior interest[126] coupled with a potential junior interest will not qualify because the senior interest insulates the holder from a measure of the enterprise risk. By contrast, those forms of contingent consideration that fail to provide such insulation would not seem disqualified.[127]

The statute provides, in its nonrecognition provisions, that an investor may not increase (substantially) his seniority in the capital structure of the corporation in reorganization.[128] A financial analysis of many forms of convertible securities issued as contingent consideration in reorganization shows that the presence of a senior interest is designed to achieve precisely that "uphill" conversion.[129] The contingent consideration may take the form, for

122. The problem of determining when to tax a transaction is a problem which runs through the accounting cases, the deferred compensation cases, and the installment sales cases, among others.

123. Fleischer & Cary, *The Taxation of Convertible Bonds and Stock*, 74 HARV. L. REV. 473 (1961).

124. *Id.* at 522.

125. This article will describe the reorganization policy that an investor not be permitted to effect a significant uphill conversion in his interest (one aspect of the continuity of interest requirement) as a requirement that the investment remain "at risk." No reference is intended thereby to whether the interest is on a recourse or nonrecourse basis as does the use of that term in I.R.C. § 465. *See generally* Dailey, *supra* note 1, at 733–34.

126. For example, debt. See Rev. Rul. 69-91, 1969-1 C.B. 16 (convertible debt).

127. For example, stock warrants.

128. Indeed, the requirements for a B reorganization may force exchanging shareholders to sacrifice some of their seniority in an exchange in which they receive voting common for their nonvoting preferred. I.R.C. §§ 354, 368(a)(1)(B). *See* Dailey, *supra* note 1, at 734.

129. This term is borrowed from D. HERWITZ, BUSINESS PLANNING 293 n.* (1966). B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.12, at 14–28 to 29, employ the term "upstream."

example, of nonvoting preferred convertible into voting common stock at a floating rate tied to the future profits of the corporation.[130] Or the contingent consideration may take the form of debt convertible into common stock with the conversion ratio tied to the corporate performance.[131] In both cases, the initial, senior interest, nonvoting preferred and debentures, respectively, ought not qualify as voting stock. The role of the senior interest in the convertible is to provide the holder with additional protection against potential enterprise risk.[132] Accordingly, under the general statutory requirement that the investor be allowed to shield no part of his interest without recognizing gain thereon, such an interest ought not to be held to qualify for nonrecognition.

This argument from analogy to the nonrecognition provisions[133] faces, with regard to voting stock, two principal challenges. First, the nonrecognition provisions apply only to reorganizations. Should their rule be applicable to determine the threshold question of whether an exchange qualifies as a reorganization? Second, the recognition rule of section 356 reaches only the portion of gain that is converted uphill, whereas the section 368 sanction would be recognition of all gain. This suggests that looking to the rules of sections 354 and 356 will yield far too harsh a result.[134]

One answer to these challenges is to look at other possible treatment for convertibles. Qualification might be allowed on a substantial equivalence test.[135] That is, if a sufficient measure of the value of the convertible were constituted by the qualifying interest, then the instrument would qualify. The recognition of gain might be computed on any of three theories. First, the entire instrument might be deemed to qualify and no gain would be recognized. This theory would seem the only one available for voting stock because the presence of any recognizable gain would disqualify the entire transaction.[136] Second, gain might be deferred

130. For example, the instrument described in Rev. Rul. 73-205, 1973-1 C.B. 188.

131. For example, the instrument described in Rev. Rul. 69-91, 1969-1 C.B. 106.

132. *See generally* M. TENNICAN, CONVERTIBLE DEBENTURES AND RELATED SECURITIES (1975) for a readable and sophisticated analysis of the finance of these instruments.

133. I.R.C. §§ 354, 356.

134. Of course, neither argument would tell against the application of this analysis with regard to qualification of convertibles as stock or securities under §§ 354, 356.

135. *See* Accounting Principles Board, Opinion No. 14 (1969) (standards for equity equivalence for the computation of earnings per share); note 5 *supra.*

136. That conclusion might not be reached were it possible to distinguish between determining that there is boot for the purposes of applying § 354 and determining that there

until a determination whether the conversion right was exercised. If not, then gain in the full amount would be recognized.[137] Third, some attempt might be made to apportion the value between qualifying and nonqualifying interests, with recognition of gain only to the extent of an unqualified interest. Both of the last two strategies appear administratively impracticable and to open broad avenues for tax avoidance.[138] These problems could be reduced by establishing a brightline test of the suspension pending conversion, after which a failure to convert would be conclusively presumed. Such a test could be coupled with a strong burden of proof on the taxpayer in the allocation of value.[139] Yet even with these two strategies, if the apportionment approach were adopted, taxpayers would probably make all their nonqualifying interests convertible, in the hope of persuading the Service that some portion was entitled to nonrecognition. The result would be an inordinate drain on Service resources.

Practically, then, it seems that there is no feasible alternative to barring initially nonqualifying interests, even if convertible into qualifying interests.[140] The broad rule against permitting initially

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is boot for the purposes of § 368. But that is a difficult argument to make in this statutory context and has not prevailed (if indeed it has ever been made) in the courts.

137. In theory, that gain should be recognized retroactively to the year of the exchange, with interest payable thereon, in order to avoid possible distortion from tax bracket shifts for the taxpayer and to minimize the deferral advantage.

138. The third proposed rule would be difficult to administer and would encourage taxpayers to set an excessive value on the conversion privilege. *Cf.* Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971) (no allocation of issuing price of convertible bonds to conversion feature in determining the original issue discount). The second rule could encourage taxpayers to set up sham conversion privileges in an attempt to defer taxation.

139. Such rules would seem within the scope of the Commissioner's rulemaking power. *See* I.R.C. § 7805(a).

140. The rule as stated here does not incorporate a distinction that makes a difference in the current law, whether the right of exercise or conversion is at the discretion of the holder of the instrument or is vested in the corporation, controlled by automatic tests. *See, e.g.*, Carlberg v. United States, 281 F.2d 507, 512–13, 517 (9th Cir. 1960). That distinction has not been defended in the literature, and at first glance seems no more persuasive than the other formal elements by which Justice Blackmun distinguished contingent rights to receive stock from stock warrants. But there is perhaps more support for the distinction. If the conversion is at the option of the corporation, or even if the conversion is triggered automatically by certain conditions, then the instrument will function less effectively for the investor as a straddle, a means by which the investor can protect himself against risk while holding open the possibility of participating in future enterprise success. Instead, the instrument looks much more as if the intent of the parties is simply to build some flexibility into the valuation of the interest exchanged in reorganization.

Although an instrument convertible or exercisable only at the option of the corporation, or automatically upon certain contingencies occurring, will function less effectively as a straddle because the conversion may occur when the holder would choose not to convert or

nonqualifying convertibles because of potential qualification upon conversion may also be defended affirmatively on the argument that the continuity of interest requirement is a requirement that the exchanging shareholder keep his investment at risk.[141]

Current reorganization law treats stock warrants much like other convertible securities.[142] The above analysis shows why that position is inaccurate: stock warrants do not carry any senior interest that violates the voting stock requirement. Stock warrants function, financially, as a super-junior security in the capital structure.[143] They do not give their holder a straddle consisting of a more senior interest and a potential, more junior interest. There is little purpose served in barring their receipt on a formal analysis that they are not voting stock.[144] Indeed, if the above analysis of the timing of the determination of tax consequences be correct, such a formal argument is not cogent because the premise that tax consequences must be determined upon realization of income is false.[145] Instead, it is entirely consonant with the statute to qualify these interests, absent an impermissible uphill conversion.

The current treatment of stock warrants may derive from a misunderstanding of their financial function.[146] The nature of the stock warrant[147] and its pricing[148] have only been understood relatively recently, even by financial analysts themselves. Previously,

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would fail to convert when he would choose to do so (and similarly for warrants), the differences are slight, and could largely be overcome by skillful drafting. Such careful drafting of the operative provisions of these instruments could cloak as automatic conversions instruments which gave the holder a large measure of control. While the Service might well be able to penetrate to the substance of the transaction, even that substance would be elusive because the holder would undoubtedly be willing to forego many rights he might otherwise have obtained in an arm's-length bargain in order to obtain nonrecognition. *See also* Gregory v. Helvering, 293 U.S. 465 (1935). So, the difference would be a difficult one to make out. Finally, it would seem that most of the bona fide sources of uncertainty in acquisitions presented in the introduction herein could be accommodated without requiring an unqualified, senior interest. Absent a clear business need, the tax law can be made simpler to administer by excluding such instruments, whoever holds the conversion power.

141. *See* note 128 *supra* and accompanying text.

142. *See, e.g.*, Treas. Reg. § 1.354-1(e) (1955).

143. *See generally* M. TENNICAN, *supra* note 132.

144. *But see* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

145. *See* notes 102-21 *supra* and accompanying text.

146. Such an explanation presumes that Justice Douglas misunderstood the role of stock warrants; that seems unlikely. Even today Justice Douglas' fundamental premise that stock warrants are very tricky instruments remains true. *See, e.g.*, Klein, *The Convertible Bond: A Peculiar Package*, 123 U. PA. L. REV. 547 (1975); L. LOSS, 1 SECURITIES REGULATION 184-86 (2d ed. 1961).

147. *See generally* M. TENNICAN, *supra* note 132.

148. *See id.*; Samuelson, *Rational Theory of Warrant Pricing*, 1965 INDUS. MANAGE-

it might have appeared that a warrant holder held a participation measured in the amount of his ultimate participation should he exercise the warrant. The warrant was the means by which he could insulate a large part of his (potential) investment from initial risk—apparently much as the holder of a convertible debenture could insulate a portion of his investment. What this characterization mistakes is the measure of the holder's participation and the seniority of the interest he holds. The value of the warrant itself measures the value of the exchanging shareholder's continuing participation, and it is a most junior participation indeed, riskier even than the common stock. If the holder chooses to exercise the warrant, he reduces the uncertainty but increases the investment at risk. Accordingly, the exercise of the warrant is not analogous to the conversion (downhill) of a security. Whatever the source of the current doctrine, it is inconsistent with the modern understanding of stock warrants.

The second possible source for this treatment of stock purchase warrants may lie in the asymmetry that would seem to be required if warrants are permitted to be acquired in exchange for stock in reorganization. Under present law, it is impermissible for a shareholder to acquire warrants for stock,[149] impermissible for him to surrender warrants and options in exchange for stock,[150] and impermissible to exchange warrants for warrants.[151] On the analysis offered above, although it ought to be proper to allow warrants to be received, to allow nonrecognition on their tender for stock would indeed permit an uphill exchange. Moreover, there seems to be no statutory support for the distinction our analysis would seek to draw between tender and receipt.[152] Because the exchange of warrants for stock would constitute an uphill exchange, it ought not to be permitted. The principal barrier to uphill exchanges is the continuity of interest requirement which ought to be applied by the Service and the courts[153] to prevent

MENT REV. 13. *See generally* B. MALKIEL & R. QUANDT, STRATEGIES AND DECISIONS IN THE SECURITIES OPTIONS MARKET (1969).

149. 315 U.S. at 201.

150. Rev. Rul. 72-198, 1972-1 C.B. 223. *See also* James C. Hamrick, 43 T.C. 21 (1964), *vacated and remanded per stipulation*, 1966-1 U.S. Tax Cas. ¶ 9322.

151. Rev. Rul. 78-408, 1978-47 I.R.B. 11.

152. The only statutory provision of such a type is that of I.R.C. § 354 which allows receipt of stock for securities, but not securities for stock.

153. Such a continuity of interest requirement would hold that the uphill conversion to a more senior position would be improper, just as in Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933), receipt of short-term notes for stock was improper.

such an exchange. In any event, this problem ought not to be very serious because a taxpayer who seeks to acquire the stock in the exchange can simply exercise his warrants prior to the exchange.[154]

C. *Contract Rights and Property Rights*

The third puzzle for contingent consideration in reorganization is whether casting such consideration in the form of contractual rights, rather than as nonqualifying property rights, ought also to disqualify the exchange in the context of B and C reorganizations or trigger recognition of gain in the context of an A reorganization. The Service position, upheld in the courts,[155] requires that control in a B or C reorganization be obtained solely in exchange for voting stock, thus operating to exclude any other consideration. The alternative reading would be that the prohibition goes only to other property transferred. There is support for both interpretations. From the Service perspective permitting unqualified contractual rights would encourage taxpayers to cast boot as contract rights. The Service sees an increase in administrative costs and a potential for illicit boot if the bar is not absolute. Opponents may urge that contract rights ought not to be disqualified because a contract right will not constitute realized income for a cash basis taxpayer[156] and thus that such future income ought not to be considered in determining the tax status of a current transaction. They may point out that if the requirement of exclusivity for the B and C reorganizations were construed to extend to contract rights and if a right to receive additional shares were cast as a contract right,[157] such an interest would disqualify the entire transaction from reorganization status. To the extent that taxpayers might well attempt to disguise unqualified property interests as contractual rights, the Service surely has the better argument that

154. To the extent that the holder can so exercise, it suggests that this problem will not often come to court and further that there is little improper in such a conversion. To that extent a court might not choose to apply the strong continuity of interest requirement described in the preceding note.

155. *See, e.g.*, Helvering v. Southwest Consol. Corp., 315 U.S. 194, 196 (1942).

156. *See generally* M. CHIRELSTEIN, *supra* note 96, at 205–08.

157. Seemingly, the Service requirement that contingent interests be nonnegotiable implicitly relies on the notion that contingent consideration is only a contractual right and therefore does not constitute either property or income when received in reorganization exchanges. This rule is also supported by a general reluctance to allow interests which can be converted into cash without loss of immediate enterprise control or equity participation. For a discussion of whether that analysis is sound, see notes 256–64 *infra* and accompanying text.

such a potential for abuse must be barred absolutely. But to the extent that such a prophylactic rule would bar from reorganization treatment exchanges that otherwise should qualify, it is unfair.

The proper test to enforce the at risk requirement of the statute would be to require that the contractual right be to a performance which, if received in the initial exchange, would qualify for nonrecognition.[158] Additionally, if the contract right is to an impermissible performance (one which would be boot if received initially) and if that right must vest or lapse prior to substantial completion of the exchange, then no boot should be deemed to have been received.

It is finally possible to offer some tentative theoretical conclusions on the proper treatment of contingent consideration in reorganizations. The previous section explored the limitations of the current law. The first step in reform is to understand that the determination of the tax status of a potential reorganization exchange need not be made at the moment the first income is realized. The rule of *Southwest Consolidated*, repeated all too often, is mistaken.[159] Instead, the tax consequences of a putative reorganization ought to be determined only upon the substantial completion of the exchange.[160] While these two rules will not often yield different results, those differences are significant.[161] Second, and more important, the terms of the statute should be interpreted in their context. In the context of a statute which requires that investors remain at risk,[162] the term "voting stock"

158. *But see* Dailey, *supra* note 1, at 776 (distinguishing between inducements to enter into a reorganization and consideration for the exchange therein).

159. *E.g.*, Carlberg v. United States, 281 F.2d 507, 514 (8th Cir. 1960).

160. What will constitute substantial completion of a reorganization exchange can be resolved in either of two ways. By administrative or legislative action, a brightline test may be adopted. An exchange might be deemed complete, for example, one year after the first consideration changed hands or after 80% of the total consideration planned in the exchange had been negotiated. *See* text accompanying note 106 *supra*. Alternatively, the courts might articulate a standard on a case-by-case method, looking to the needs of administration, the intent of the parties, the business purpose of the contingent consideration, and other related factors. It is beyond the scope of this article to evaluate which would be the better approach to this problem.

161. For example, in a B reorganization the exchanging shareholders receive a contingent right to a large cash payment within one year of the exchange if litigation does not go to a successful conclusion. The substantial completion rule will not disqualify the exchange but will instead wait to see if the payment is made, before determining the tax status of the transaction.

162. This is the requirement of continuity of interest, articulated in Treas. Reg. § 1.368-1(b) (1955), and the requirement of I.R.C. § 354.

should be construed to include voting stock warrants, contingent voting stock, escrowed voting stock, and similar interests. But because of the fundamental at risk requirement of the statute, those convertible interests that carry an initially unqualified, more senior interest, ought not to be held to qualify. Third, neither the Service nor the courts ought construe the statute to bar contractual consideration in B and C reorganizations. To the extent that these theoretical analyses open tax-avoidance abuses, the continuity of interest doctrine and the *Gregory* analysis seem sufficient to control taxpayers.[163] Having resolved the fundamental theoretical problems, it is now possible to review the application of those general rules to the three classes of consideration articulated in the statute.[164]

III. THE PRACTICE OF TAXING CONTINGENT CONSIDERATION

A. *Nonrecognition of Loss and Gain on the Exchange*

1. *Voting Stock*

Congress enacted the "solely for voting stock" restriction for stock and asset acquisitions in 1934.[165] That restriction has proved remarkably durable. It has also proved problematic and seemingly poorly drafted.[166] Although the legislative intent was clearly to restrict the scope of reorganization status,[167] there remains substantial uncertainty even today regarding the precise import of that particular provision. The problems of the provision have been carefully and systematically explored by Richard R. Dailey.[168] It is sufficient here to note that the provision is very likely over- and under-restrictive; the requirement will bar attempts to acquire a corporation in which a large part of the stock is nonvoting by an exchange for nonvoting stock, and it will permit the exchange of voting preferred for common stock.[169] There are good arguments that neither exchange is consonant with the statutory scheme.[170] Even if the general limits of the requirement

163. Gregory v. Helvering, 293 U.S. 465 (1935). For a discussion of the possibilities of tax avoidance, see notes 235–64 *infra* and accompanying text.

164. They are voting stock, stock, and securities. *See* I.R.C. §§ 368, 354, 356. There is a fourth residual category, other property, but all gain is always taxed on the receipt of such property, and so is of no interest here.

165. Revenue Act of 1934, Pub. L. No. 216, 48 Stat. 705.

166. *See generally* Dailey, *supra* note 1.

167. *See, e.g.*, S. REP. No. 558, 73d Cong., 2d Sess. 16–17 (1934).

168. *See* Dailey, *supra* note 1.

169. *Id.* at 737. *See also* Hellerstein, *supra* note 105, at 260–61, 272–76.

170. *See generally* Dailey, *supra* note 1.

are known today, there remains some difficulty in applying the requirement to contingent consideration.[171]

Using the theoretical analysis outlined above,[172] however, will resolve most of these problems. First, all contingent consideration that embodies only a series of time variant rights, each of which would qualify as voting stock, ought itself to qualify as voting stock. For example, voting, convertible preferred stock should qualify.[173] Second, looking to the function of the voting stock requirement, property interests that will either give rise to a voting stock interest or lapse ought to qualify. Thus stock warrants, contingent voting stock, and escrowed voting stock should qualify.[174] Third, contractual options to acquire voting stock should not disqualify a transaction.[175] Contractual rights to receive additional dividends, even though imbedded in stock instruments, may well be impermissible because they give rise to cash boot.[176] Thus the law for contingent consideration in B and C reorganizations can be outlined very simply in light of the preceding theoretical analysis.

But one final challenge remains. According to the reasoning of *Southwest Consolidated* the term "voting stock" should be read narrowly to exclude most of the interests described above.[177] That position can be answered in either of two ways. The strongest ar-

171. For example, what measure of voting rights must be satisfied in the case of a contingent interest in additional voting stock? Must escrowed stock allow the beneficial owner to vote the stock during the period? If not, what duration may the escrow have? These questions have not been addressed by the courts, the Service, or the commentators; and the answers, judging from the law of what qualifies as voting stock generally, are not apparent.

172. *See* Section II, *supra*.

173. *See* Rev. Rul. 73-205, 1973-1 C.B. 188.

174. It may be proper, however, to restrict the receipt of stock in exchange for the tender of stock warrants as an uphill exchange. *See* notes 150–54 *supra* and accompanying text.

175. This would reverse the current law. *See* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942); Treas. Reg. § 1.354–1(e) (1955).

176. Such receipt is, however, permissible under present law. *See* Rev. Rul. 75–33, 1975–1 C.B. 115. *But cf.* Rev. Rul. 66–112, 1966–1 C.B. 68 (*Carlberg* nonacquiescence based, in part, on rights to dividends on contingent stock).

177. 315 U.S. at 200–01. Although the "plain meaning" style of statutory interpretation has been very seriously challenged as vacuous and incoherent, it still has its supporters. *See generally* H. HART & A. SACKS, THE LEGAL PROCESS 1145 (tentative ed. 1958). For a recent decision following that model, see William H. Bateman, 40 T.C. 408 (1963), *appeal dismissed* (4th Cir. Jan. 28, 1964). Of course, if the theoretical foundations of Justice Douglas' interpretation are rejected, that opinion itself, relying as it does on an appeal to the "plain meaning" of the statute, will hardly be persuasive. Because that style of interpretation remains vital, however, this article attempts to persuade even those who adopt Justice Douglas' premises in *Southwest Consolidated.*

gument is that from the functional model. There is no support in the language or purpose of the statute that would warrant treating reorganization exchanges made under uncertainty so differently from certain reorganizations. The statutory nonrecognition language and purpose are served by treating voting stock warrants and related instruments as voting stock. If that premise is rejected, there can be no principled allowance of any form of contingent consideration.[178] Second, the argument of *Southwest Consolidated* may itself be challenged. Realization of income should not be the event which triggers a determination of whether nonrecognition is proper but rather the substantial completion of the reorganization exchange. Once it is admitted that the Service and the courts must look to the substance of these transactions, there is no argument that they ought not look into the substance of the contingent rights as well. Thus even the premise of Justice Douglas' argument seems open to serious challenge. So there seems no strong argument, save from the most dogmatic, formalist position, against the use of these forms of contingent consideration in reorganization.

2. *Stock*

The two-tier approach of section 354(a) is a recent addition to the nonrecognition provisions for corporate reorganizations.[179] But the theory is not novel: it is simply another codification of the continuity of interest principle.[180] Perhaps because the term "stock" is often used elsewhere in the Code[181] (as is the term "stock or securities"),[182] the difficulties seem to have been less severe than in the definition of "voting stock." There has been far less reported litigation on the question of what qualifies as stock in the reorganization context. In the field of contingent consideration, the stakes are much the same as with voting stock,[183] the

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178. The reasoning of *Carlberg* and the revenue procedures that permit the use of contingent and escrowed stock is, under this view, simply ad hoc in nature, designed to reach the right result. Because those authorities are unable or unwilling to restrict *Southwest Consolidated* to its facts, the practical and theoretical inconsistencies and ambiguities described in Section I *supra* naturally arise. This position is buttressed by those provisions of the Internal Revenue Code and the treasury regulations thereunder that provide that stock options and warrants will be treated as stock. *E.g.*, I.R.C. §§ 305, 306.

179. The change was made in the enactment of the 1954 Code.

180. *See generally* B. BITTKER & J. EUSTICE, *supra* note 8, at 14-16 to 26.

181. *E.g.*, I.R.C. §§ 301-306.

182. *E.g.*, I.R.C. §§ 181, 191, 311(d)(2)(D), 333(f)(2).

183. The fundamental difference is that the presence of boot in a B or C reorganization may force recognition of all gain, whereas boot in an otherwise qualifying transaction will

analysis much the same, too. Thus contingent and escrowed stock, convertible preferred, and stock warrants and options ought all to qualify as stock for the purposes of nonrecognition in a reorganization. To conclude so easily that there is little difference between the construction of the scope of the term "voting stock" and the term "stock" may seem to ignore the different statutory contexts of the two terms.[184] But the difference in statutory context only reinforces the expansive reading offered above with regard to contingent consideration. The section 354 requirement that stock alone be entitled to unqualified nonrecognition supports the interpretation that any more senior interest be recognized insofar as there is gain. This statutory provision reinforces the argument above that convertible debt ought not to qualify for nonrecognition. On the other hand, such a provision might be construed to require an allocation between the value of the convertible debenture attributable to the debt interest and the value attributable to the stock interest.[185] On this approach, only the former would be ineligible for nonrecognition.

The argument against allocation—an argument unnecessary in the context of a B reorganization and of limited importance for a C reorganization for which additional boot will be sufficient to disqualify the entire transaction[186]—must be based on the potential for taxpayer abuse and the lack of business justification for such a feature. The potential for illicit tax avoidance lies in the ability of taxpayers to use sham convertible debt and to manipulate its value to defer gain in a reorganization.[187] A taxpayer seeking to defer his tax on a reorganization exchange in which he obtained a large measure of debt might attempt to camouflage a large part of the value of that debt by masquerading the instrument as a convertible and attributing an improperly great portion

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trigger recognition of gain only to the extent of the value of the nonqualifying property received.

184. *See* text accompanying note 78 *supra.*

185. *See, e.g.*, Treas. Reg. § 1.356–1(c), Example 1 (recognition determined by valuation of taxable assets received in § 356 transaction) (1955). *See generally* 3A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 21.32 (rev. ed. 1977).

186. I.R.C. § 368. It would be unnecessary because allocation is required only with regard to the carryover basis and the nonrecognition of gain, neither of which are relevant in a taxable acquisition in which all gain is recognized and a cost basis is assigned. I.R.C. § 358. For a C reorganization allocation may be necessary if nonqualifying consideration is employed pursuant to I.R.C. § 368(a)(2).

187. The valuation of convertibles is a difficult and complex task. It is, moreover, a project which achieves its results with little certainty. *See* M. TENNICAN, *supra* note 132, at 7–9.

of the value to the potential equity interest. In such a world, all debt in reorganization exchanges would be convertible, only some would be convertible at more favorable terms than others. The Service would have little remedy against such schemes.[188] Thus, a prophylactic rule ought to be adopted and convertible debt treated as debt, not stock.[189]

This conclusion is supported by the recognition that the inclusion in the convertible of a nonqualifying senior, debt instrument serves no purpose in the allocation and reduction of risk and uncertainty in the acquisition, the business reasons which may justify contingent consideration. Whatever contingencies are anticipated, they may be dealt with effectively by means of convertible preferred.[190] If in the future preferred stock should be disqualified as voting stock in B and C reorganizations, then the parties will no longer be able to increase the seniority of their interests in B and C reorganizations. Contingent and escrowed stock would still be permissible, as would stock warrants. If the at risk requirement were extended consistently to bar the exchange of voting common for voting preferred (as an uphill exchange), there would still remain multiple devices by which the uncertainty could be allocated as contingent consideration. The disqualification of preferred stock in reorganizations which today permit only voting stock would block the receipt of convertible preferred. Such a bar ought not otherwise affect the use of contingent consideration. Under the present statute, if the parties seek the seniority of debt, they must be prepared to recognize gain in accordance with the provisions of sections 354 and 356.

3. *Securities*

The second part of the 1954 enactment of the continuity of interest requirement was a restriction of nonrecognition upon the receipt of securities to the principal amount of securities ten-

188. Although an allocation of burden of proof might make the taxpayer's case more difficult, the taxpayer would ordinarily be in a far more informed position than the Service and be able to produce the evidence necessary to establish any reasonable valuation, however high.

189. *Cf.* Rev. Rul. 77-437, 1977-2 C.B. 28, 29 (convertible debt treated as debt until conversion for purposes of determining gain on cancellation of indebtedness in a recapitalization).

190. For an analysis of the financial role of convertibles, see M. TENNICAN, *supra* note 132, at 11-23. "Convertible preferred stocks are nearly identical to convertible debentures." *Id.* at 22.

dered.[191] The treasury regulations provide that stock warrants and options do not qualify as securities.[192] Because stock warrants and options are ordinarily thought of as securities, at least for the purposes of federal securities regulation,[193] it seems anomalous to stipulate by administrative fiat that they are not included in the term "securities" for the purposes of sections 354 and 356. One argument in support of such a conclusion, however, is that the term "securities" does not include stock within its scope.[194] Therefore, why should the term include within its scope even more junior interests like stock warrants?[195] We have urged above that the term "stock" should include, for tax purposes, interests like stock warrants and options as is provided in other contexts of subchapter C. However, if the precedents are too difficult to overturn at the administrative level, such interests ought to qualify as securities because such interests are ordinarily considered securities, at least in the overarching federal securities regulation context,[196] and because such inclusion would not do violence to the statutory scheme of requiring exchanging shareholders in a reorganization to keep their investment at risk. Therefore, although the emerging pattern seems initially anomalous, there is no persuasive argument against including stock warrants and options as securities, if such interests are not qualified as stock. There are,

191. The legislative history, beyond demonstrating the obvious intent to restrict further the availability of reorganization treatment, is strangely silent on the choice of language to reach that result. In particular, there is no indication why the statute employs the standard of principal amount rather than a standard of value. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1955), *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4623, 4682.

192. Treas. Reg. §§ 1.354-1(e), .355-1(a) (1955). The formal argument against stock warrant qualification has initial appeal, at least with respect to qualification as voting stock. Ordinary usage does not usually include voting stock warrants within the rubric of voting stock, nor does the law of corporations. *See* A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 151-52, 180-85 (1933); A. DEWING, A STUDY OF CORPORATION SECURITIES 17-32 (1934). But those appeals both disappear with regard to qualification of stock warrants as securities if they will not qualify as stock. The federal securities law and ordinary usage usually classify stock warrants as securities. So the presumption here is on the other side, and it would seem that if stock warrants do not qualify as stock (a fortiori as voting stock), they ought at least to qualify as securities. Thus there seems very little support for the current treasury regulations to the contrary.

The only support for the regulations might come from the argument that since warrants have been held not to qualify either as voting stock (*Southwest Consolidated*) or as stock (*Bateman* and *Gordon*), they must fail to qualify as securities which are tacitly *debt* securities. D. HERWITZ, *supra* note 129, at 106.

193. Securities Act of 1933, § 2(1), 15 U.S.C. § 77(a) (1976).

194. Although the statute does not explicitly so provide, only such an interpretation reconciles the varying treatment of stock and securities.

195. *See* D. HERWITZ, *supra* note 129, at 106.

196. *See* note 193 *supra*.

however, two theoretical problems regarding the characterization of contingent consideration as a security. First, the terms of section 354(a)(2) provide for the nonrecognition of gain on receipt of securities only if the principal amount received is not more than the principal amount of securities tendered. That provision does not easily apply to stock warrants without principal amount. Second, assuming a short-term note of insufficient duration to qualify as a security,[197] would a provision for the conversion of such a note into preferred stock at the option of the holder qualify the note as a security?

The language of section 354(a)(2) would support an argument that stock warrants cannot qualify as securities.[198] Assume that stock warrants are securities, without face amount. If they are received in an exchange in which no securities are tendered, then section 354(a)(1) is inapplicable according to section 354(a)(2)(B), and gain, in the amount of the fair market value of the warrants, is recognized pursuant to section 356(a)(1). But on appeal to section 354(a)(2)(A) rather than section 354(a)(2)(B), section 354 is applicable and because the principal amount of the securities received ($0) does not exceed the principal amount of the securities tendered ($0), no gain is recognized. Thus, the *reductio* goes, accepting warrants as securities leads to an inconsistency in section 354. This argument has not been made by the Service or in the courts; the support for the current treasury regulations is presumed to come by analogy to *Southwest Consolidated*.[199] The apparent paradox is hardly insoluble if the intent of the statute is considered. The purpose was to bar uphill conversions without recognition. That policy is not served by recognizing gain in the amount of the fair market value of the warrants; it is served by according those warrants nonrecognition.[200] Thus section 354(a)(2)(A) rather than section 354(a)(2)(B) should govern.

Turning to the second problem, it must be recognized that the problem of defining the scope of the term "securities" has been very real, at least since *Pinellas Ice & Cold Storage Co. v.*

197. Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933).

198. *See* William H. Bateman, 40 T.C. 408, 413–14 (1963), *appeal dismissed*, (4th Cir. Jan. 28, 1964).

199. B. BITTKER & J. EUSTICE, *supra* note 8, at 14–75. Under the statute construed there, however, this argument could not be made. The 1934 Revenue Act made no provision for the two-tier treatment of stock and securities introduced in the 1954 Code.

200. This conclusion follows from the policy of denying nonrecognition in an otherwise qualifying exchange if the taxpayer achieves an uphill exchange in the reorganization. *See* notes 142–48 *supra* and accompanying text. *See also* Dailey, *supra* note 1, at 778–79.

Commissioner.[201] Although the rule of that case, a requirement that securities have a minimum duration, seems mistaken,[202] that rule has been firmly established in the current law of reorganization.[203] Thus it appears that a short-term note, that would not itself qualify, raises peculiar problems when it carries a conversion privilege into common stock. But the puzzle is largely a theoretical one; such instruments rarely occur.[204] The argument from analogy presented above would seem to have little weight because the class of consideration at issue, "securities," is the most senior interest, and there are interests senior to short-term notes which will qualify as securities.[205] So if an argument against the short-term note is to be made, it must be on the terms of the reorganization doctrine which contrasts reorganization with sale in the restructuring of control of an enterprise.[206] As the court reasoned in *Pinellas*, the shareholder who receives a short-term note, even if a portion of that note represents its conversion feature, has received in part a cash equivalent.[207] Since such receipt is taxable, even in reorganization, the value of the short-term note independent of the conversion privilege ought to be taxable. In addition, because of the possible manipulation of convertibles by shareholders, the entire value of the instrument should be taxable.[208] Therefore, a short-term note subject to a convertible feature ought not qualify as a security.[209]

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201. 287 U.S. 462 (1933). For a trenchant criticism of this decision and its progeny, see Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945).

202. The confusion, according to Griswold, *supra* note 201, arises from infusing the definition of the term "security" with the requirement of a reorganization, continuity of interest. The result is that a short-term note, more senior than stock but less senior than long-term debentures, both of which qualify, is itself unqualified under *Pinellas* as well as Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945).

203. *See generally* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.31, at 14–75 to 76.

204. They rarely occur, presumably because even more than convertible debentures the convertibility feature and the short-term note play different roles in finance, the one deferred equity financing and the other short-term capital funding. Also, the two appeal to investors with very different risk preferences. Thus it is not surprising that no case or ruling request has been reported in which such an instrument has been employed, independent of the tax uncertainty its use would engender.

205. Griswold, *supra* note 201, at 725.

206. *See* Treas. Reg. § 1.368-1(b) (1955).

207. *See generally* Mylan, *Cost Recovery as a Method of Reporting Gain from Dispositions of Property*, 8 WILLAMETTE L.J. 1 (1972); Comment, *The Doctrine of Cash Equivalency as Illustrated by Land Sales Contracts and Notes Received for Services Rendered*, 22 U.C.L.A. L. REV. 219 (1972).

208. *See* notes 128–32 *supra* and accompanying text.

209. Of course, if with Griswold it is concluded that the continuity of interest requirement ought not to be construed to bar such short-term interests as securities, either on the argument from analogy noted at note 196 *supra*, or on the argument that the period of

4. *Conclusions*

The principal task here has been to show how the application of the theoretical analysis outlined in the preceding section can yield a clear and consistent doctrine governing contingent consideration in reorganizations. The pattern that emerges differs greatly from the present law. First, instruments like stock warrants and stock options, today denied nonrecognition even as securities, a fortiori as stock, ought to be permissible consideration in a reorganization. Second, the limitations placed upon contingent and escrowed stock are unnecessary. Because these instruments are deemed to qualify, the restrictions are unwarranted. By legitimizing the use of such contingent consideration, it is also possible to expand its scope.[210] Third, however, the present bar against classification of many forms of convertible senior securities as stock or as voting stock is upheld, on the argument that such instruments give their holder an impermissible straddle. Finally, although current law permits shareholders to receive special dividends, this interest may well constitute a cash equivalent and thus ought to trigger recognition of gain. The principle that emerges from these rules is that the substantive rights of the parties govern the tax consequences of the transactions; little turns on the names of the instruments or whether the rights are embodied in property or in contracts. Such a law will at once effect the legislative policy and allow corporate planners to provide for uncertainty in corporate acquisitions. The principal remaining problem is how, given this potential increase in flexibility during reorganization, the carryover basis provisions operate.

B. *The Treatment of Basis*

For taxpayers the crucial feature of reorganization treatment is nonrecognition of gain or loss. But together with the provision for nonrecognition treatment, the Code provides for carryover bases for the acquiring corporation[211] and the shareholders of the acquired corporation (the corporation's basis is sometimes termed

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nonrecognition for a short-term note is sufficiently short that the temporary deferral is not improper, then a fortiori a convertible short-term note ought to qualify as a security. However insubstantial the rationale for the holding in *Pinellas* and the cases that follow, that rule is well imbedded in the law of reorganizations.

210. For a discussion of the uncertainties in the present law, see notes 78–81 *supra* and accompanying text.

211. I.R.C. §§ 358, 362.

"substituted").[212] The former takes the basis held by the exchanging shareholders plus any gain realized by the transferor. Thus in a stock swap the corporation takes as its basis in the stock it acquires the basis therein of the exchanging shareholders. The shareholders retain in the new shares their old basis. Because contingent consideration is ordinarily paid by the acquiring corporation in return for a certain consideration from the exchanging shareholders,[213] there are rarely special basis problems for the corporation. It simply acquires the shareholders' old basis. But insofar as the shareholder has received an uncertain consideration, he may encounter either of two particular problems in the determination of his basis during the life of the contingent consideration.

The first problem is the simpler of the two. It may be styled a problem of *horizontal* allocation. For example, assume that an exchanging shareholder exchanges in a B reorganization his stock and receives in return for each share of stock tendered two shares initially. Additionally, he receives a contingent right to receive two additional shares of the acquiring corporation if in any one of the following three years the performance of the acquired corporation reaches a certain level.[214] Assume further that the right to receive the additional shares is a right of the record holder as of the reorganization. If such a shareholder sells the following year, prior to the issuance of the additional stock and prior to the determination that such stock will be issued, what is his basis in the stock sold? The taxpayer would like to allocate the full aliquot share of the carryover basis to the shares sold; the Service would like to allocate one-half of the initial basis.[215] There is little law on this matter, although the Service position is clear.[216]

Prima facie, any one of five theories might be applied to define

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212. *Id.*

213. In theory, of course, the contingent consideration could be paid by the shareholders. But since the acquiring corporation seeks immediate control of the acquired corporation in the acquisition, such contingent consideration must be in a form other than the shares tendered in the stock swap or other reorganization proceeding. This alone raises significant difficulties. Additionally, however, the transaction costs would be much increased by requiring additional payments, of whatever form, from a multitude of parties. Thus, in practice, the contingent consideration seems always to be paid by the acquiring corporation.

214. Under this plan, the taxpayers would be entitled to an affirmative ruling on the exchange under Rev. Proc. 77-37, 1977-2 C.B. 568.

215. *Id. See also* Tillinghast, *supra* note 1, at 476.

216. Rev. Proc. 77-37, 1977-2 C.B. 568. For advance rulings the maximum number of contingent shares must be stated at the outset. If, however, the maximum number of shares were not stated, it would seem permissible for the Service to assume a potentially infinite number of shares and assign a zero basis to the shares initially received.

the proper allocation. First, the exchange might be styled an open transaction,[217] in which there would be no gain realized until there had been a total recovery of basis. The open transaction theory might operate in either of two ways. First, the initial, fixed consideration might be removed from the calculation because entitled to nonrecognition. The return of the basis, then, would apply only to the additional, contingent payout. Such a rule would, except in those cases in which the contingent payouts exceed the substituted basis, insulate the entire transaction from taxation. Under the second open transaction approach, the entire amounts received might be deemed to be a return of basis, and any contingent payments received in excess of basis would be taxable. This method would involve no special rules derived from the nonrecognition provisions and is simply a direct application of the *Burnet v. Logan* rule.[218] Third, it might be presumed that no basis was properly allocated to the future shares prior to issuance, and so the shareholder would be entitled to deduct his full carryover basis for the aliquot share of any stock disposed of. Fourth, an attempt might be made to allocate the value between the present shares and the rights to receive additional shares and then allocate the carryover basis in proportion to value. Fifth, it might be presumed that all stock which could be issued would be issued and the shareholder entitled to allocate only a fraction of his proportional basis with the denominator based on the number of shares potentially received. This is the current Internal Revenue Service position.[219]

Given the multiplicity of theories available, it is not initially apparent which ought to govern. In a case in which the uncertainty was so great that the open transaction doctrine should apply,[220] it would seem that the rule of basis recovery stated in *Burnet v. Logan*[221] ought to apply. But in the far greater number of cases there can be no initial recovery of basis.[222] The general rule under the Code provides for the allocation of basis among

217. *See* Burnet v. Logan, 283 U.S. 404 (1931).

218. *Id.*

219. Rev. Proc. 77-37, 1977-2 C.B. 568.

220. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.56, at 14-142; M. CHIRELSTEIN, *supra* note 96, at 242.

221. 283 U.S. 404 (1931).

222. In particular, this result is proper in those cases in which there is not sufficient uncertainty to hold that the assets have no fair market value. *Cf.*, *e.g.*, Morrison v. Commissioner, 59 T.C. 248, 259-61 (1972) (valuation of warrants for tax purposes).

assets;[223] it would require an allocation between the actual consideration initially received and the contingent consideration. The danger in such a rule is that the taxpayer who had realized gain and knew which interest he would liquidate first could assign to it a higher basis and achieve an unjustified tax deferral.[224] The compromise approach, which assumes that one-half of all contingent shares are issued and apportions the basis ratably among the property received, may seem a safer approach from the Treasury perspective. There are, however, two principal drawbacks. First, there would always have to be subsequent basis adjustments when the actual number of shares exchanged became known. Second, such a rule would give the taxpayer a non-zero basis only when the contingent consideration had an upper limit. Although such a limit is imposed today,[225] there is little support for such a rule. It appears that the general rule should govern here; the possibility of manipulation seems little greater than in other areas of the law.

Far more complicated problems of basis determination arise with the introduction of more complex forms of contingent consideration. These can be styled problems of *vertical* allocation. For example, assume that instead of receiving either of the contingent stock deals described above, the exchanging shareholder would receive in the B reorganization for each share tendered one share of common stock and one common stock warrant entitling him to purchase an additional share at the current market price. There would seem to be no option but to require an allocation of value to the two elements of consideration received and to assign a basis to each in proportion to its value.[226] To assign to either ele-

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223. *See* 3A J. MERTENS, *supra* note 185, at § 21.32.

224. Insofar as these would be nondepreciable assets, what basis the taxpayer assigns to the various assets might not have to be determined until a disposition, in which case a higher basis could be applied to that asset which is disposed of first. *Compare* I.R.C. §§ 167, 1016 *with* I.R.C. §§ 1001, 1002.

225. *See* Rev. Proc. 77-37, 1977-2 C.B. 568, 569.

226. Support for such a strategy can be found in the current treatment of the issue price of bond warrant units in computing the original issue discount. According to Treas. Reg. § 1.163-4(a), the issue price of a bond warrant package may be allocated between the bond and the warrant according to their respective values. T.D. 7213, 1972-2 C.B. 482. If the treatment of the original issue discount can be founded on such an allocation of value, it would not seem improper also to require such allocation to determine carryover basis in reorganizations.

By contrast, however, the treasury regulations prohibit the allocation of a portion of the issue price of a convertible debenture to the conversion feature. Treas. Reg. § 1.163-4(a), T.D. 7213, 1972-2 C.B. 482. That rule against allocation has been upheld in the courts. AMF, Inc. v. United States, 476 F.2d 1351 (Ct. Cl. 1973); Hunt Foods, Inc. v. Commissioner, 57 T.C. 633 (1972), *aff'd per curiam*, 496 F.2d 532 (9th Cir. 1974); Chock Full

ment a greater than proportional basis might allow the taxpayer to defer gain, or alternatively, impose an inequitable burden on his liquidation of less than all classes of consideration received in the exchange. Even if a proportional basis were carried over, there would be obvious possibilities of taxpayer manipulation.[227] A final difficulty arises if warrants are never exercised and instead lapse. Does the taxpayer then properly report a loss? Such a result would be inconsistent with the analysis that the warrants were received as an integral element in an ongoing reorganization exchange.[228] The proper treatment instead would seem to be to allocate the basis previously assigned to the stock warrants to the other consideration received. But even such a bald rule would encounter difficulty if, in the interim, the shareholder had sold his shares. In such a case, either the taxpayer would be burdened with a disappearing basis[229] or he must be allowed to recognize his loss. The latter result is probably preferred.[230]

O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971). No attempt will be made here to evaluate the distinction between the two problems that the court attempts to draw. For our purposes, it is sufficient to note that there is little support for extending the rationale of *Chock Full O'Nuts* to the reorganization provisions. Absent such an affirmative rationale, there is no reason to treat bond warrant units and convertible bonds, functionally so similar, so differently in the tax law. *But see* 453 F.2d at 305.

227. *See* note 224 *supra* and accompanying text.

228. At present, a taxpayer who disposes of an interest acquired in a reorganization exchange recognizes gain or loss thereon. I.R.C. §§ 1002, 1012. There is no applicable nonrecognition provision. To the extent, however, contingent consideration is permitted in reorganizations, then allowing taxpayers to recognize loss on the lapse of warrants or conversion rights will permit them to defer taxation. At a more theoretical level, permitting contingent consideration requires that exchange relationships must be taxed differently from exchange transactions, and that for such relationships recognition of loss must await the substantial disposition of the consideration. In short, once the tax treatment of an exchange relationship is determined on a holistic approach, fragmentation cannot be reintroduced. A similar approach has been taken in § 356, which allows only gain to be recognized on the receipt of both nonrecognition property and boot, in an attempt to restrict the possibility of manipulation. *But see* Rev. Rul. 78-376, 1978-42 I.R.B. 51 (gain recognized on return of escrowed stock received in a reorganization).

At a practical level, a continued nonrecognition rule may be defended on the argument that it is the sole rule sufficient to prevent illicit tax avoidance.

229. The disappearing basis is a burden, *ceteris paribus*, because it entails that a taxpayer will have been taxed on gain which was in fact only recovery of basis or that he will have been denied a loss.

230. This case seems clearly distinguishable from the ordinary case in which the warrants lapse prior to a disposition of the taxpayer's other interest because the taxpayer has liquidated his entire position in the enterprise. A similar situation can arise with regard to § 306 stock when preferred stock is distributed on common stock. On the total disposition of the common, the question arises as to how to treat the gain on the sale of the § 306 stock. It is generally provided that in such a case the taint has disappeared. To the extent that the dividend stock is allocated a basis and then taxed as ordinary income on the proceeds of a disposition, that basis can be reallocated to the common. *See generally* B. BITTKER & J.

Perhaps the best treatment for these basis problems is simply to require the allocation of basis among the assets received, contingent as well as certain, in keeping with the general allocation rules.[231] But the additional limitation ought to be imposed, as detailed above, that loss would be recognized on the liquidation (nonreceipt) of the contingent consideration only if the entire investment in the certain consideration had previously been liquidated.[232] In the event that the certain consideration had not been liquidated, the proportion of the basis initially allocated to the contingent consideration ought to be reallocated to the certain consideration. These rules will obviously not provide a fair solution in all cases, and there may be some opportunity for misallocation by taxpayers of the value in an attempt to gain an improper tax advantage.[233] But the potential for harm does not seem egregious because the rule proposed compromises the claims of the Service to presume the payment of the contingent consideration in full and the preference of the taxpayer to allocate a basis to the contingent consideration only when realized.[234]

IV. TAX AVOIDANCE WITH CONTINGENT CONSIDERATION

The preceding exploration of the problems of nonrecognition and basis carryovers for contingent consideration in reorganizations may have seemed shortsighted. Whatever may be the rheto-

EUSTICE, *supra* note 8, at ch. 10. That distinction makes a difference because in the case of a total liquidation the lapse of the warrants to which the taxpayer had assigned a basis appears more nearly like an event of realization. By contrast, when warrants lapse while a taxpayer's stock interest continues, only a mere change in the form of the taxpayer's interest has occurred.

231. *See* J. MERTENS, *supra* note 185. *Cf.* note 226, *supra* (original issue discount determined on allocation of issue price to warrant in bond warrant unit, but not to conversion element in convertible bonds).

232. Compare the treatment of § 306 stock described in note 230 *supra.*

233. For example, a taxpayer anticipating sale of the noncontingent stock at a loss soon after the reorganization and in a year when other independent losses are to be taken may wish to preserve in full a portion of that loss for a future year when gains are anticipated rather than be subject to the loss carryover rules of I.R.C. § 1212(b). By use of contingent rights sure to lapse in the desired year (after all the noncontingent rights have been sold), a portion of the loss may be postponed in full to that year in the amount of the basis assigned to the sure-to-lapse contingent interest. It would be difficult indeed to police such an attempt. To the extent that a reorganization promises to operate as such a manipulative device, it is clearly within the Commissioner's discretion to refuse to rule affirmatively under § 7805, which would likely inhibit such transactions. Of course, such a transaction could also be challenged after the fact as a sham.

234. This scheme is consistent with the general Code provisions for the allocation of basis, cost, or carryover. *See generally* 3A J. MERTENS, *supra* note 185, § 21.32.

ric of the law here,[235] the reality is that the Service and the courts are today principally concerned with the potential of such consideration for illicit tax avoidance.[236] The two forms such avoidance may take are the conversion of personal compensation into capital gains accorded nonrecognition in a reorganization and the bailout of earnings and profits from a corporation as contingent consideration taxed only as deferred capital gains.[237] An easing of the restraints on the use of contingent consideration in reorganizations may make such tax evasion easier. Accordingly, given the apparent importance ascribed to the potential abuses, those abuses and their impact on the reforms here proposed will be examined.

The reorganization provisions, like section 337, are intended to shelter only certain kinds of gain on a qualifying exchange.[238] But articulating the limits of the countervailing judicial doctrines and Code provisions[239] with respect to the reorganization provisions is not easy. The first stage is to gauge the policies that according nonrecognition to all gains in reorganizations would allegedly offend. The first policy is that of taxing personal service compensation as ordinary income on its receipt. A variety of Code provisions seek to assure this result: principally relevant are section 61 defining gross income, section 83 providing for the taxation as ordinary income of property received in exchange for services, and sections 421 through 424 on taxation of employee stock options.[240] The common thread of these provisions is that

235. The rhetoric, as is demonstrated in Section I *supra*, is one of the formal interpretations of the statutory language.

236. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.56, at 14–143 to 144.

237. Although there are some other problems, *e.g.*, the receipt of boot in the form of contingent consideration and the attempt to masquerade speculative transactions as reorganizations, the former has been adequately explored above, and the latter seems a very limited problem, if contrary to the language and purpose of the statute at all.

238. This is especially clear in the case of the reorganization provisions that provide for nonrecognition only on the gain and loss realized on the exchange of property. Even the broader nonrecognition provisions of §§ 336 and 337 have been persuasively shown to be limited by the tax benefit rule. O'Hare, *Statutory Nonrecognition of Income and the Overriding Principle of the Tax Benefit Rule in the Taxation of Corporations and Shareholders*, 27 TAX L. REV. 215 (1973). But litigation continues. *See* Tennessee Carolina Transp., Inc. v. Commissioner, 65 T.C. 440 (1975), *aff'd*, 582 F.2d 378 (4th Cir. 1978)(resolution of conflict between tax benefit rule and I.R.C. § 336).

239. *E.g.*, I.R.C. § 1002; *see* Treas. Reg. § 1.1002–1(b) (1960).

240. Such a policy is, of course, inherent in the overall income tax scheme, but it is especially strong with regard to personal service income since such income constitutes by far the greater portion of income for most taxpayers. In order to maintain the integrity and equity of the present system, such as it is, tax avoidance in this regard must be severely circumscribed.

The § 83 restricted stock provisions, for example, were enacted because taxpayers were

compensation for personal services, notwithstanding its form as stock or other property, is to be taxed as ordinary income when realized. This policy is sufficiently important that certain provisions, among them those of section 83, impose prophylactic rules to block potential avoidance.[241] Although those rules may impose hardship in particular cases, they have been upheld in the courts.[242]

If a taxpayer succeeded in converting compensation income into deferred capital gains in the course of the reorganization, it would appear that the statutory policy requiring realization and recognition on receipt as ordinary income would be thwarted. For example, if corporation Y seeks to acquire closely held corporation X, in which all the stock is held by the current management, and the purpose of the acquisition is to secure a supply of the X products for use in the Y enterprise, it might be attractive to both parties to continue the current management of X under long-term management contracts. If there is uncertainty about the valuation of X corporation, provision might be made for the issuance of contingent rights to additional Y shares should X performance reach specified levels. In this case it might be in the interests of both parties to provide for more contingent shares than required by the valuation uncertainties coupled with a lower salary for the management. If such additional shares were deemed received in the reorganization, they would not be initially taxed and would ultimately be taxed only at capital gains rates, a very substantial saving for the management. All that Y would lose would be the deduction for the difference in salaries for its subsidiary, X. If this deal were so structured that nonrecognition were obtained on the additional shares paid, in fact, as personal service compensation, the statutory policy would seem to have been thwarted.

One reply to the challenge that contingent consideration will provide taxpayers with another means of tax avoidance would assert that, insofar as nonrecognition is granted and the corporation must forfeit the deduction for compensation,[243] the possibility of

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avoiding the taxation on receipt, as ordinary income, of personal service compensation. *See* S. REP. No. 91-552, 91st Cong., 1st Sess., *reprinted in* [1969] U.S. CODE CONG. & AD. NEWS 2027, 2150-52.

241. Thus I.R.C. § 83 takes no account of the diminution of value by virtue of the restrictions on negotiability. I.R.C. § 83(a)(1). This will result in an overstatement of the income received.

242. Sakol v. Commissioner, 67 T.C. 986 (1977), *aff'd*, 574 F.2d 694 (2d Cir. 1978).

243. I am indebted to Professor William D. Andrews for calling this argument to my attention.

disguising compensation income as contingent consideration in a reorganization exchange will neither be so attractive to the parties nor as dangerous to the fisc as is presumed above.[244] The parties will have bought the lower personal tax with a higher corporate tax. While there is merit in this criticism, to pretend that the tax avoidance challenge is so easily disarmed is to miss the duty of fidelity to law. Under present law a corporation is not permitted to buy such a tax benefit for its management. This is the lesson of section 83 of the Code and the new stock options rules. [245] Whatever the sources of the current law,[246] and whatever its merits, a taxpayer cannot achieve tax benefits consistent with the stat-

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244. An example may help demonstrate why the loss of the corporate compensation deduction will diminish the attractiveness of disguising compensation as contingent consideration. Assume a corporation X, with income substantially above the $100,000 surtax exemption, and a corporate officer subject to a 50% maximum personal service tax rate and a 60% tax rate on investment income (thus a 24% capital gains tax rate). If the officer receives $100,000 straight salary, the corporation will receive a deduction worth $46,000 and the individual will pay $50,000 in taxes. If, however, the corporation pays him $75,000 in salary with the remainder of the compensation paid as disguised contingent consideration in a reorganization, the corporation will obtain only $34,500 in deductions. The individual will pay $37,500 in taxes and realize (but not recognize) a capital gain of $25,000, on which he must ultimately pay $6,000 in taxes. Ignoring the discount factor (the advantage of deferral), such a strategy would leave the corporation and its officer $9,000 poorer than paying direct compensation. The deferral effect will, of course, operate to reduce this loss. But because a high bracket taxpayer is in virtually the same bracket as a large corporation, the loss of the corporate deduction will largely (if not entirely) offset the gain of converting ordinary income into capital gain.

245. That lesson follows from the response of Congress to foreclose such attempts to allocate tax benefits in this context. I.R.C. § 422 (originally enacted as Tax Reform Act of 1976, Pub. L. No. 94-455, § 603, 90 Stat. 1520); H.R. REP. No. 94-658, 94th Cong., 2d Sess. 171-73, *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 2897, 3065-66. In general, of course, there is often no objection to the allocation of tax benefits.

246. There are two principal rationales for such a rule. First, it may be thought that allowing the corporation to purchase such a tax benefit for its management may enable that management to obtain excessive compensation because most shareholders, when they examine the compensation paid to executives, will be unaware of the different tax costs to the corporation of the different forms of compensation. Corporation law, however, lacks any very meaningful restrictions on executive compensation. *See, e.g.*, ALI-ABA MODEL BUS. CORP. ACT §§ 4(k), 4(o), 20 (1953). Manipulation of the tax law to the same end seems at best a remote approach. *See also* W. CARY, CASES AND MATERIALS ON CORPORATIONS 565 (4th ed. 1969) (fairness standards for directors dealing with their corporations).

The second argument for such a general rule of taxation on realization is one of fairness. Individuals, receiving the same type of income in the same amount, should be taxed at approximately the same rates. Of course, if the taxpayer has purchased the tax benefit from the corporation, it is to be presumed that the purchase was made with a portion of the otherwise taxable income he would have received in lieu of the nontaxable compensation. In such a case, the taxpayer would be entitled to the tax benefit. The only objection to such a conclusion would be that the purchase was made from an unequal bargaining partner, on the argument above, and therefore such transactions should be discouraged by denying taxpayers the tax benefit they seek. *Cf.* I.R.C. § 72 (treatment of annuities).

utory policy by receiving compensation taxed at capital gains rates.

After articulating the policy of realization-as-ordinary-income as a "no tax benefit" policy, the next step is to determine how it applies in the context of reorganization. No countervailing policy in reorganizations allows compensation income to be taxed at capital gains rates.[247] Such a principle, if it existed, might indeed override a policy requiring realization of compensation income on receipt.[248] But the principle of nonrecognition exchanges is limited to gain or loss realized on the exchange of property; the compensation income in question clearly fails to fall within the ambit of the nonrecognition provisions.[249] Support for such an interpretation of the law is found in the short shrift given the taxpayer's argument for nonrecognition of such compensation in *LeVant v. Commissioner*.[250] In that case, the taxpayer had been employed by an unincorporated business, with the provision that after eight months the taxpayer would be given an option to acquire twenty percent of the theretofore sole proprietorship. Subsequently the proprietorship was incorporated without any specific provision having been made for the issuance of additional shares if LeVant, the taxpayer, elected to exercise his option. Thereafter, the corporation was acquired in a reorganization by Colgate-Palmolive. The taxpayer argued that the shares he received in that transaction constituted payment for shares of Edison, Inc., his employer. The reviewing court dismissed that argument, noting that "petitioner's conveyance to Colgate of the claim he had against Edison, however it be characterized, was not in substance or otherwise an exchange of Edison shares for those of Colgate."[251] Thus, to the extent that a taxpayer can disguise compensation income as contingent consideration in a reorganization he will have reaped an improper tax advantage.

A prophylactic rule against contingent consideration in reorga-

247. The language of the provision applies, in principle and on its face, only to gain realized on the exchange.

248. For example, if the ability of taxpayers to shift the form in which they held their continued investment were at stake. *See* Treas. Reg. § 1.1002-1(c) (1960): "The underlying assumption of these exceptions [to the general rule of recognition] is that the new property is substantially a continuation of the old investment still unliquidated . . . ."

249. *Compare* I.R.C. § 83(a) *with* §§ 354(a), 368(a).

250. 376 F.2d 434 (7th Cir. 1967). *See also* Morrison v. Commissioner, 59 T.C. 248 (1972) (stock options received by management in merger held compensation under I.R.C. § 61(a)).

251. 376 F.2d at 441.

nizations would prevent disguised compensation. A limitation on the types of contingent consideration qualifying in reorganizations and the limits on contingent consideration, such as exist under present law, might yield similar benefits.[252] Thus there is an argument for strict limitations. Before deeming such an argument dispositive, it is necessary to consider: first, whether in the face of such a policy taxpayers could otherwise obtain the improper tax advantage of converting ordinary compensation income into deferred capital gains and, second, whether more limited regulation might not sharply reduce the potential for abuse as well. Even if contingent consideration were barred in reorganization, taxpayers could still disguise future compensation as unrecognized gain on the exchange. For example, in the stock acquisition described above of a closely held corporation with continuing management, additional shares might be paid to the management in lieu of a portion of their future service compensation, with provision for forfeiture or liquidated damages should the manager leave the employment of the acquired corporation. If such a transaction received the tax treatment sought by the parties, the shares received in the exchange would constitute disguised personal service income and would obtain both deferral and capital gains treatment.[253] Perhaps barring the use of contingent consideration might make such schemes more transparent. Yet on the facts de-

252. For business reasons there will be limits to the duration of disguised compensation agreements; the present Service restriction on contingent stock payouts, five years, roughly coincides with this practical constraint. Consequently, that limit on duration is probably of little effect in controlling this problem. Even if management desired a capital gains conversion, it would be difficult to extend employment contracts longer than five years.

253. Although at one time such damages might have been difficult to enforce, liquidated damages are today far more easily obtained, when reasonable. The potential long-term relationship and the availability of the funds to pay the damages would both contribute to the likelihood of a court enforcing such a provision. So it would seem that such a provision might be an alternative to drafting the attempt to manipulate the tax benefit through contingent consideration. *See* A. CORBIN, CONTRACTS §§ 1054–1070 (2d ed. 1964); J. MURRAY, CONTRACTS § 234 (1974). Indeed, virtually any manipulation through ordinary contingent consideration forms could just as easily be obtained through the use of a certain consideration in the reorganization and a contractual provision for liquidated damages under the employment contract. I.R.C. § 83(d). A badly drafted provision for liquidated damages might constitute a substantial risk of forfeiture under I.R.C. § 83, subjecting the taxpayer to taxation on the appreciation of the stock until the restriction lapses. But a well drafted provision would appear as a liquidated damage provision of an executive employment contract, and would not trigger the application of §§ 83(a) and 83(c)(1). It is unclear whether such an arrangement would fall within the scope of Rev. Proc. 77-37, 1977-2 C.B. 568, 570. If such an arrangement were deemed a condition imposed pursuant to a plan of reorganization, the ruling guideline would apply. On the other hand, the Service does recognize that employment agreements may be ancillary to, rather than incorporated in, reorganization plans. *E.g.*, Rev. Rul. 77-271, 1977-2 C.B. 116, 117 and authori-

scribed above, the Service would have to inquire rather deeply into the economic realities of the entire deal to discover that the damages upon termination constituted one element in a plan to convert future ordinary income into unrecognized capital gain.[254] The possibility of abuse can be policed, however, by less drastic restrictions on contingent consideration.

The potential for abuse of contingent consideration exists only in a small class of corporate acquisitions, those in which the exchanging shareholders will continue to receive substantial ordinary income from the acquired or acquiring corporation. Excluded are those cases in which the shareholders are not the managers of the acquired corporation and those cases in which the acquisition marks the termination of employment for the previous management.[255] The Service might shape the remedy by looking more carefully at the scope of the problem, rather than proposing general restrictions. Looking then at the acquisition of closely held corporations with provision for continuing management, the Service might first require a description of the business purpose of the contingent consideration. If the source of the uncertainty were pending major litigation, for example, this burden would be easily met. If, however, the source of the uncertainty were simply a bargaining impasse, perhaps the Service should remain suspicious. Second, the Service might consider the relationship between previous compensation and compensation after the acquisition. A decline in compensation or a failure to increase compensation in the light of increased responsibilities might each signal an illicit attempt to avoid taxes. Third, the Service might look to the measure of compensation received by shareholders and the measure of contingent consideration received; if these seem too nearly proportional, there is again cause for concern. The above factors, of course, do not delineate precisely how the Service ought to treat this problem. But the possibility of improper tax avoidance is

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ties cited therein. If the latter analysis were applied, such an arrangement would not be policed by Rev. Proc. 77-37.

254. Perhaps the only force that such an objection has is that attempts to manipulate tax advantages are more readily perceived for what they are in the context of an employment contract, less likely to be so perceived in the context of an apparent property exchange. This objection is easily answered in the following paragraph by the rules proposed for the policing of contingent consideration employed to obtain deferred capital gains treatment.

255. These cases will not be included because in the first class of cases there will be no compensation for personal services paid to the exchanging shareholders, and in the second class there will be no future compensation for which capital gains treatment could be sought. *See* Morrison v. Commissioner, 59 T.C. 248 (1972).

very slight in a transaction in which there is a clear business purpose for the amount of contingent consideration employed, there is no reduction in executive compensation nor increase in responsibilities, and contingent consideration is not proportional to compensation. However these tests are applied, by shifting the burden of proof or as conclusive presumptions, the Service can defeat possible attempts to employ contingent consideration to disguise ordinary income received for personal services.

The second possible tax avoidance strategy for contingent consideration is to distribute the earnings and profits of the corporation as capital gains rather than as dividends taxable as ordinary income.[256] The instant bailout traditionally takes the following form. The shareholders of a corporation receive a nontaxable stock dividend. They sell the stock so received to third parties, recognizing only capital gains on the sale, and the corporation then redeems the stock from the new shareholders, who also recognize only capital gain.[257]

This pattern seems closely paralleled by the two following uses of contingent stock or stock warrants.

> *Case 1.* Warrants (or contingent stock) are issued to shareholders of an acquired corporation in a merger. The shareholders subsequently sell the warrants (or contingent stock) to third parties, from whom the warrants are redeemed prior to exercise (or the contingent rights are repurchased prior to realization).
>
> *Case 2.* Warrants (or contingent stock) are issued to the shareholders of an acquired corporation in a merger. The warrants (or contingent stock rights) are subsequently sold to third parties. The warrants are never exercised (or the contingent stock is never issued).

In both cases, the shareholders will recognize only capital gain through the sale to third parties, and the initial shareholders will suffer no dilution in either control or profit participation. Formally, then, these uses of contingent consideration would seem to constitute analogous types of bailout. Having posed the issue, we must further explore first what forms of contingent consideration pose this potential problem. Second, how serious is the problem if

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256. The many varieties of bailouts have been catalogued by Professor Robert C. Clark in his analysis of the structure of subchapter C. Clark, *The Morphogenesis of Subchapter C*, 87 YALE L.J. 90 (1977).

257. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶¶ 10.01–.07; Chamberlin v. Commissioner, 207 F.2d 462 (6th Cir. 1953), *cert. denied*, 347 U.S. 918 (1954).

it is not dealt with under existing statutes? Finally, we examine whether section 306 and related sections already provide a solution to this problem.

The bailout problem is raised only by independent, severable forms of contingent consideration. That is, if the contingent rights cannot be negotiated to a third party independently of the underlying equity participation with respect to which they were distributed, then the shareholder cannot dispose of his contingent consideration without also disposing of his equity. For example, if the contingent consideration takes the form of convertible preferred stock, no bailout can occur in this form. Nor can the problem arise if the contingent consideration is in the form of warrants attached to convertible stock and exercisable only on conversion. But in the case of stock warrants, contingent stock, or escrowed stock, this possibility of a sale to a third party without affecting the underlying equity is real.

Two principal arguments weigh against the use of such instruments in a bailout. First, the investors who buy the contingent consideration will be buying a very risky asset. Accordingly, outside investors will properly be very hesitant to give full value for the warrants.[258] Second, the risk of dilution of control is present, together with the potential dilution of equity. The shareholders who employ such consideration in a bailout will have taken a far greater gamble than those who employ low-risk preferred stock. These two drawbacks ought to be sufficient to limit the use of contingent consideration in bailouts.[259] Accordingly, as a rule, any contingent consideration not qualifying as section 306 stock[260] ought not to be treated as effecting a bailout.

The final question is whether such bailouts are curtailed by existing statutory or judicial doctrine. The only Code provision directly relevant is section 306. But section 306 does not, on its face, reach the many forms of contingent consideration which are not section 306 stock, that is, stock other than common stock re-

258. Economically, the explanation is simply that the outside investors will confront an asymetrically greater risk than do the issuing, controlling shareholders. *Cf.* M. TENNICAN, *supra* note 132, at 14-15 (warrant lacks "downside" protection of convertible).

259. If a taxpayer were to couple the distribution of contingent consideration with a disposition and redemption by the corporation, then an abuse might be present. The taxpayers in control of the corporation could insure the redemption and thus protect against even the slightest risk of dilution of control or participation in the future. But if such a plan were adopted, the Service could easily penetrate its form to tax the shareholders on a constructive dividend.

260. I.R.C. § 306(c).

ceived in a tax-free distribution to the shareholder. Some of the contingent consideration interests which pose the problem of improper tax avoidance would qualify as stock, *e.g.*, escrowed and contingent stock. If "stock" is given a broad scope, perhaps on the argument that section 306 is a remedial provision, then stock warrants, as well as convertible, contingent, and escrowed stock, would also qualify. So perhaps the problem, such as it is, is already adequately solved by the current law.

The concern with potential abuse of contingent consideration has received little explicit attention. It is perhaps because the potential abuses have been subjected to so little direct scrutiny that they have played such an important role in the formulation of policy. Had these two arguments been given a full examination, their force would today be greatly diminished. The first, the concern that taxpayers may employ contingent consideration to defer taxation on compensation income and ultimately pay only at capital gains rates, is genuine. But the threat seems no more serious than the other ways in which taxpayers may seek this result and is a problem by no means limited to reorganizations. It is both inefficient and ineffective to attempt to realize such a policy by restricting the use of contingent consideration in reorganization.[261] Moreover, such a restriction will violate the clear statutory policy in favor of nonrecognition of gain on such exchanges.[262] The argument that contingent consideration will be employed to bailout earnings is even less persuasive. In the main, contingent consideration cannot be used for such purpose.[263] To the extent that it can be so employed, its use is probably reached under the current statutes.[264] While the possibility of tax avoidance with contingent consideration must be addressed if such consideration is permitted

261. It is inefficient to attempt to realize such a policy by directly restricting contingent consideration because such a policy will cut against the realization of the countervailing policy of permitting the shuffling of investments in reorganizations. The strategy is inefficient because, as indicated, the tax abuses can be achieved without recourse to contingent consideration.

262. *See* Treas. Reg. § 1.1002-1(c) (1960).

263. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.31, at 14-77; note 258 *supra* and accompanying text. The unsuitability of contingent consideration for this purpose is rooted in the very contingency of the interest. Bailouts employ more certain interests which can easily be negotiated without loss of control. The speculative nature of contingent consideration and the frequency with which such interests carry a potential control element both count very heavily against the use of such interests in a bailout much as they count against the use of contingent consideration as an interest payment. *But see* note 13 *supra*.

264. I.R.C. § 306.

in reorganization, that possibility can hardly support any ban against such use.

V. The Possibility of Reform

This article has focused upon the failure of the present law to cope adequately with the problems of tax-free corporate acquisitions under uncertainty. Its purpose has been to expose the fragility of the status quo as well as to propose the administrative and legislative solutions that might allow the current reorganization provisions to better solve these complex problems.

A. *The Status Quo*

The current law is founded, in large part, on two very weak foundations. The first is that of Justice Douglas' opinion in *Southwest Consolidated*.[265] As has been argued in preceding sections, the argument that warrants cannot be employed in B and C reorganizations is virtually without merit, as is the extension of that doctrine by the courts and by the Service. The rule ought to have been that voting stock warrants are permissible in reorganizations when justified by a business purpose. The second dubious foundation for the current treatment of contingent consideration is Justice Blackmun's opinion in *Carlberg*.[266] The distinctions drawn between contingent stock and stock warrants, while perhaps well intentioned, are insubstantial. Thus current contingent consideration, employed in reliance on Justice Blackmun's opinion, rests on an unsound foundation. Finally, the use of convertible preferred stock, increasingly common, is itself on weak ground. Although technically in compliance with the statute which mandates only voting stock, the use of preferred stock is at least arguably inconsistent with the at risk requirement of reorganization status.[267] Although the voting stock requirement has survived without significant amendment, and perhaps will continue so to survive, there is strong reason to believe that the use of preferred stock is inconsistent with the statutory scheme. Thus the use of convertible preferred stock as the paramount form of contingent consideration, as doctrinally fragile as that use is, is particularly troubling when a reconsideration of the purposes of the

265. 315 U.S. 194 (1942).

266. 281 F.2d 507 (8th Cir. 1960). This article argues that *Carlberg* reaches the right result, but that its path is open to criticism. *See* notes 46–71 *supra* and accompanying text.

267. *See* Dailey, *supra* note 1, at 778.

statutory provisions and a critical scrutiny of the precedents supports a much broader use of other forms of contingent consideration.[268]

B. *Legislative Solutions*

These problems admit of simple legislative solutions. Congress could overturn the result in *Southwest Consolidated*[269] by means of a simple amendment to section 368. A new subsection, 368(d), should be added, to read:

> STOCK WARRANTS AND CONTINGENT AND ESCROWED STOCK—For the purposes of this part voting stock warrants and escrowed and contingent voting stock will qualify as voting stock. For the purposes of this part stock warrants and escrowed and contingent stock will qualify as stock.

Enactment of such an anti-*Southwest Consolidated* provision would immediately overturn all the limitations imposed by that opinion, and the doctrines erected in the wake of *Carlberg* by the Service.[270] Such an amendment would put contingent consideration in tax-free corporate acquisitions on a firm foundation.

No explicit statutory provision is necessary to provide for allocation of basis between certain and contingent consideration, as that is the general rule.

C. *Administrative Solutions*

The same result can, in the main, be obtained by administrative action. The principal source of operative law regarding contingent consideration comes not from the bare holding in *Southwest Consolidated* but from the administrative interpretation of that decision, the revenue procedures governing contingent and escrowed stock, and the regulations disqualifying stock warrants

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268. Realist critics of the reorganization provisions may, however, view the analysis of contingent consideration in reorganizations as a *reductio ad absurdum* for those provisions. *Cf.* Hellerstein, *supra* note 105 (realist critique of reorganization provisions). Thus, to the extent that the reorganization provisions are founded on the premise that recognition of gain or loss is inappropriate because the investor holds only a continuing interest in the enterprise, albeit in a new form, the presence of uncertainty and risk in the reorganization sufficient to compel the use of contingent consideration strongly indicates that the investment is not merely continuing in a new form. Instead, the presence of contingent consideration indicates a radical revision of interests. Therefore, it may appear that nonrecognition is inappropriate.

No attempt will be made here to respond to this radical challenge to the reorganization provisions; it is sufficient to note that there may well be exogenous policy considerations which justify the reorganization scheme.

269. 315 U.S. 194 (1942). *See* notes 19–33 *supra* and accompanying text.

270. *E.g.*, Treas. Reg. § 1.354–1(e) (1955).

as stock for the purposes of section 354.[271] If the Service withdrew that revenue procedure and announced that contingent and escrowed stock would be permitted to the extent that they were justified by a business purpose and that the transactions involving the acquisition of closely held corporations with provision for a continuation of management would be subject to special guidelines, much of the problem could be cured. Similarly, if the regulations under sections 354 and 356 were amended to provide that stock warrants would qualify as stock for the application of those provisions, *Southwest Consolidated* would be effectively confined to its facts. The only aspect of the current law which needs reform that could not be reached administratively is the qualification of voting stock warrants in B and C reorganizations, and the failure to qualify warrants in those contexts will, of course, inject a measure of inconsistency in the law. But the majority of problems could be solved, doctrinally, by action of the Service.

D. *Practice in the Interim*

The problems of the taxation of contingent consideration are largely doctrinal and theoretical problems. The current guidelines for the use of convertible preferred stock and contingent and escrowed stock permit a wide variety of contingent consideration. As a practical matter there are undoubtedly few acquisitions which fail because of uncertainty which cannot be resolved because of tax reasons. At the same time, because the revenue procedures governing contingent and escrowed stock are so restrictive and because most practitioners do not apply for rulings which fall outside those limits, a brief review of the probable limits for contingent consideration, as they would be understood by courts, is valuable.

Three principles emerge. First, any attempt to employ stock warrants in a reorganization will be risky, at best. Because of the continued vitality of *Southwest Consolidated*, warrants remain today a forbidden form of contingent consideration.[272] Second, the most flexible and safest form of contingent consideration is convertible preferred stock. So long as an interest can properly be characterized as convertible preferred, there is little likelihood of challenge. Precisely what the boundary is between stock warrants

271. Rev. Proc. 77–37, 1977–2 C.B. 568; Treas. Reg. § 1.354–1(e) (1955); *see* notes 34–45 *supra* and accompanying text.

272. 315 U.S. 194 (1942); Rev. Rul. 78–408, 1978–47 I.R.B. 11.

and convertible preferred is not clear. For example, if a share of preferred stock entitles the holder to convert to common at a fixed price plus one-half of the difference between the market price and the fixed price, is this convertible preferred or convertible preferred with an attached stock warrant? How a court would resolve this puzzle cannot be safely predicted.

Third, although the Service limits the available use of contingent and escrowed stock, the courts would probably adopt far more flexible rules for such devices. If a suitable business purpose dictated the structure of a transaction, it appears unlikely that

(a) a maximum number of shares must be determined;
(b) the shares must be issued within five years;
(c) fifty percent must be issued initially; and
(d) dividends must be initially payable.

Of course, the business purpose must justify each and every feature of the contingent stock. But it is hard to believe that a court would tax the payout of contingent shares over a period not to exceed the period of litigation on a matter of substantial import even if that litigation drew out beyond five years; or, with respect to payment of dividends, if the dividends were paid into escrow to fund dissenters' rights. Of course, violating any of these Service guidelines will require counsel to look very closely at the substance and the purpose of the contingent consideration. For the counsel willing and able to undertake such scrutiny, it ought to be easily possible to extend the use of contingent and escrowed stock beyond the controlling revenue procedures,[273] even without reform.[274]

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273. Rev. Proc. 77-37, 1977-2 C.B. 568.

274. *See* B. BITTKER & J. EUSTICE, *supra* note 8, ¶ 14.56, at 14-143.