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GALLAGHER REVISITED:
THE FUNCTIONALLY UNRELATED CORPORATE
REORGANIZATION

WILLIAM D. LIPKIND†

I. INTRODUCTION

ONE OF THE TRADITIONAL talismans that permeates American Jurisprudence is the elevation of substance over form. Both the Internal Revenue Service and the federal judiciary have properly utilized this principle to vitiate taxpayers' attempts to avoid tax liability. However, unique problems develop when, in certain sections, the federal tax structure provides rather detailed provisions for discerning tax consequences. Individuals comply with these provisions, as interpreted, in their business dealings, but the Internal Revenue Service on occasion concludes that, nonetheless, there is tax avoidance.

This Article will focus on these problems in the area of corporate liquidations and reincorporations. Under the current tax laws, markedly diverse tax consequences can result from characterizing a corporate transaction as a liquidation-reincorporation or a reorganization. However, the operative facts that qualify a transaction as within either of these categories can be created by the taxpayer. Naturally, the Commissioner has argued that attempts to qualify under a particular section, in order to have advantageous tax consequences, should be disregarded as mere formal compliance, and that, therefore, the transaction should be treated in a different manner. The reaction of the judiciary to this approach and the soundness of this reaction will be the primary point of departure for this Article.

II. THE CONFLICTING APPROACHES

The genesis of the problem is that "dividends" are taxable at ordinary income rates¹ whereas amounts received in exchange for the

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1. INT. REV. CODE OF 1954, § 316 provides that any distribution of property made by a corporation to its shareholders, out of its earnings and profits, is a dividend. [Hereinafter references to the 1954 Code will be by section only]. Section 301(c)(1) then provides that dividends are includable in gross income just as section 61 provides that wages are includable in gross income.

stock of a corporation² or in the liquidation³ of a corporation are entitled to the favorable capital gains treatment.⁴ Therefore, shareholders in closely held corporations with retained earnings have often eschewed ordinary dividends and sought, through various procedures, to liquidate their corporation, and transfer⁵ the operating assets to a new corporation.

Two significant cases have been decided within recent years in this liquidation-reincorporation area, each representing an antithetical approach to the resolution of the issue of what tax consequences shall result from certain corporate activity. In order to outline the general type of corporate activity involved, and to highlight the divergent approaches, these two cases will be discussed initially. A detailed analysis of the applicable Internal Revenue Code sections and their legislative histories will then be undertaken.

In *Joseph C. Gallagher*,⁶ the Tax Court dealt with the liquidation and reincorporation of West Coast Terminals, Inc. In 1946, West Coast had been organized as a Delaware corporation to engage in the stevedoring business in the Los Angeles and San Francisco areas. The business proved to be successful and by 1955, although dividends had only been paid twice in the nine year period, the corporation had a retained earned surplus in excess of \$800,000. However, four stockholders, owning 38.05% of the stock, were not active in the business, and a number of managerial personnel held no shares. Therefore, in order to eliminate the inactive stockholders, permit seven employees to acquire an equity interest, and withdraw the substantial retained earned surplus, the shareholders voted to liquidate the corporation on June 14, 1955.

Pursuant to the plan, West Coast Terminals, Inc., a California corporation, was formed on June 17, 1955. In exchange for \$300,000 in cash, the five active shareholders of the Delaware corporation received 72.67% and the seven employees received 27.33% of the common stock in the new corporation. The California corporation then purchased Delaware's operating assets for the book value of \$100,264.56. During these transactions, the stevedoring business continued

2. Section 1221 defines "capital asset" so as to include corporate stock. Section 1222(3) defines "capital gain" to be the gain from the "sale or exchange" of a capital asset held for more than 6 months.

3. Section 331 provides that amounts received by shareholders "in complete liquidation" of a corporation are to be given capital gains treatment as an amount "in full payment in exchange for the stock."

4. Sections 1201 and 1202 provide that the maximum tax on capital gains shall be 25%.

5. Section 351 makes the transfer tax free.

6. 39 T.C. 144 (1962), *appeals dismissed*, Nos. 18844, 18845 (9th Cir., Sept. 23, 1965), *affirmed*, 368 U.S. 417 (1962), *cert. denied*, 378 U.S. 907 (1964). CUM. BULL. 5.

without interruption. Delaware proceeded to liquidate and distributed \$1,000,000 in cash in 1955 and \$78,521 in cash and property in 1956. Although all of Delaware's shareholders reported the amounts received in excess of their adjusted bases as capital gains, the Commissioner assessed deficiencies against four of the five⁷ continuing shareholders on the ground that the amounts which they received were fully taxable as dividends.

The Commissioner advanced two theories. In the first instance he argued that there was, in substance, no "complete liquidation"⁸ and that the distribution was, therefore, a dividend under section 301, thereby implying that it was not within section 302(b)(1). In the alternative, he argued that there was a "reorganization" within section 368⁹ and that the distribution constituted "boot" under section 356 in that it constituted property not within sections 354 or 355.¹⁰

A majority of the Tax Court rejected both arguments. In rejecting the first, the court held that there was full compliance with the liquidation sections and that if there is to be ordinary income treatment in a liquidation-reincorporation case, it must be within the reorganization sections. Moving to the Commissioner's second contention, the court concluded that there could be no (D)¹¹ reorganization because of the absence of "control"¹² immediately after the transfer. The Commissioner argued that some steps in the transaction could be disregarded as being unessential to the "dominant purpose," which he characterized as the withdrawal of corporate earnings and a continuation of a substantial equity interest. This argument was dismissed

7. The opinion of the court does not reveal whether a deficiency was also assessed against the fifth active and continuing shareholder.

8. Section 331(a)(1) provides: "Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock." Section 331(b) provides that section 301 shall not apply.

9. The word "reorganization" is defined in section 368(a)(1).

10. Gain on Exchanges.—

(1) Recognition of Gain.—If—

(A) section 354 or 355 would apply to an exchange but for the fact that

(B) the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money,

then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Section 356(a).

11. [A] transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders . . . is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

Section 368(a)(1)(D) [hereinafter referred to as a (D) reorganization].

12. "[C]ontrol" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote. 1968 Pub. L. No. 95-208, § 1361(c), 82 Stat. 1479. See also *Wallerstein*, 1968-1 CB 181, 182. Section 368(c) [hereinafter referred to as "control"].

with little consideration. In so doing, the court refused to find either an (E)¹³ or (F)¹⁴ reorganization.

However, if the Commissioner's position were accepted — that the withdrawal of some shareholders and the sale of stock to new shareholders could be disregarded — then the remaining transaction would be merely a shift in the state of incorporation and a distribution of money, and there would be a 100% continuity of interest of the shareholders. As such, the control requirement of (D) would be met. In the alternative, the transaction would be little more than a mere change in name, form, or state of incorporation, thereby constituting an (F) reorganization together with a dividend.

The three judge minority believed that the court should block what it viewed as a transparent device and concluded that since there was a "continuity of business enterprise," there was no complete liquidation under the rationale of *Bazley v. Commissioner*.¹⁵

Four years later, in *Davant v. Commissioner*,¹⁶ the Commissioner finally convinced a court that transactions in the liquidation-reincorporation area could be segmented in order to isolate a reorganization and tax the distributions as boot. The Commissioner's concern was precipitated by the fact that the liquidation of the corporation was accompanied by a concomitant transfer of its operating assets to a sister corporation. Four families each owned a 25% interest in both the South Texas Rice Warehouse Company, a Texas corporation formed in 1936 for the purpose of carrying on the business of drying, cleaning, and storing rice, and the South Texas Water Company, a Texas corporation formed in 1934 in order to rent land to South Texas Rice Farms and to hold and operate an irrigation canal system used to irrigate the ricelands it leased to Farms. Warehouse obtained its rice mainly from Water. Farms was a partnership of the four families and re-leased the land to tenant farmers who paid Farms with 50% of their rice crop. Although the books and records were prepared separately for the three businesses, they were all kept in one office.

By 1960, Warehouse had accumulated earnings and profits of \$160,132.29 and Water had accumulated earnings and profits of

13. "[A] recapitalization. . . ." Section 368(a)(1)(E) [hereinafter referred to as an (E) reorganization].

14. "[A] mere change in identity, form, or place of organization, however effected." Section 368(a)(1)(F) [hereinafter referred to as an (F) reorganization].

15. 331 U.S. 737 (1947). In *Bazley*, a closely held corporation exchanged its \$100 par value stock for no par stock and debentures. The Supreme Court held that the debentures were to be taxed as an ordinary dividend and that the transaction was not a tax-free recapitalization. The Court's analysis of the transaction is pregnant with seeds of confusion. See p. 514 *infra*.

16. 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967), rev'g in part and affirming *Silvan v. South Texas Rice Warehouse Co.*, 43 T.C. 540 (1965).

\$658,884.66. The shareholders wished to transfer Warehouse's operating assets to Water for \$700,000 and then liquidate Warehouse. Their attorney advised them that the Commissioner would probably deny them capital gains treatment and treat the distribution as an ordinary dividend. Therefore, following the advice of their attorney, the parties sold all of their Warehouse stock to the attorney's son who then sold Warehouse's operating assets to Water and liquidated Warehouse. Although the son participated in the actual transfers, he never took part in the formulation of this plan. On August 26, 1960, the son borrowed \$914,200 from a bank and bought all of the Warehouse stock with this sum. Water then bought Warehouse's assets for \$700,000 and the son subsequently liquidated Warehouse. The son received \$230,000 from Warehouse's bank account, paid back the loan with interest of \$152.37, and made \$15,583.30 for himself. All of this took one hour and none of the businesses were ever disrupted.

The taxpayers argued that this was a bona fide sale; the Commissioner contended that there was a reorganization. The Tax Court held that there was a (D) reorganization and that the gain was taxable as a dividend to the extent of Warehouse's earnings and profits.¹⁷ The court of appeals held that there was no complete liquidation within the meaning of section 331, that there was both an (F) and a (D) reorganization, and that the distribution was a dividend to the extent of the earnings and profits of Water, as well as of Warehouse.¹⁸ In order to reach this result the court of appeals combined all of the transactions and found that although the stockholders severed themselves from the corporate shell, they did not sever themselves from the business, and, therefore, a complete liquidation did not occur. Then, separating the steps and disregarding the distributions of cash, the court found an (F) reorganization in that the transfer of ownership of the operating assets from Warehouse to Water was a mere change of form. The use of Water's earnings and profits to determine the amount of the dividend was justified on three alternative grounds. The court, citing *Bazley*,¹⁹ found a section 301 dividend functionally unrelated to the reorganization. In the alternative, the court held that the cash was boot under section 356, with two distributing corporations, or that under section 482²⁰ the earnings and profits of Warehouse

17. South Texas Rice Warehouse Co., 43 T.C. 540 (1965). See § 316.

18. 366 F.2d at 884, 887.

19. See note 15 *supra*.

20. In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among the organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation

and Water could be combined and considered as one distributing corporation.

A. The Theoretical Divergence

The significance of the *Gallagher* and *Davant* cases is not in their results, but in their underlying theories. To combat attempted tax avoidance by taxpayers who structure transactions as liquidations with a subsequent transfer of assets to a new corporation, the Commissioner has used the reorganization sections.²¹ Section 368 defines a reorganization; section 354 is the operative section establishing criteria for the non-recognition of gain or loss, and section 356 is the operative section providing for dividend treatment for property, other than stock or securities, distributed in a reorganization. In general terms, the 1939 Code provided for similar results.²² In addition to possible dividend treatment, a further incentive for the taxpayer to avoid the reorganization path is that assets received by the transferee corporation do not get a stepped-up basis for depreciation purposes if the reorganization sections are applied.²³

Under the 1939 Code, the Commissioner treated these liquidation-reincorporation or sale of assets-liquidation (or preincorporation)²⁴ transactions as (D) reorganizations.²⁵ The reorganization provisions were applied when the old corporation transferred assets to the new

is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.
Section 482.

21. The best discussion of the reincorporation problems is in Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218 (1964). See also B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS § 12.22 (2d ed. 1966); 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION §§ 20.91, 20.92, 20.94, 20.95 (rev. ed. 1965); Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CIN. L. REV. 304 (1959); MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958); Nicholson, *Recent Developments in the Reincorporation Area*, 19 TAX L. REV. 123 (1964).

22. Int. Rev. Code of 1939, ch. 1, § 112(g)(1), 53 Stat. 40, as amended, ch. 247, § 213(b), 53 Stat. 870 (1939) [hereinafter referred to as Int. Rev. Code of 1939] defined a reorganization. Int. Rev. Code of 1939, ch. 1, § 112(b)(3), provided for tax-free treatment to the exchange of stocks and securities, and Int. Rev. Code of 1939, ch. 1, § 112(c)(2), provided for dividend treatment for the boot.

23. See generally Levin, *The Case for a Stepped-Up Basis to the Transferee in Certain Reorganizations*, 17 TAX L. REV. 511 (1962).

24. A "preincorporation" is a transaction where the shareholders of a corporation create a new corporation, cause the old corporation to transfer or sell its operating assets to the new corporation, and then cause the old corporation to be liquidated. Just as with a liquidation-reincorporation where the old corporation is liquidated and the shareholders transfer the operating assets to a new corporation, the shareholders have a going business and cash in their pockets.

25. Int. Rev. Code of 1939, ch. 1, § 112(g)(1), defined a reorganization as: (A) a statutory merger or consolidation, or . . . (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

for stock and then liquidated,²⁶ when the old corporation transferred assets to the new for cash and then liquidated,²⁷ and when the old corporation liquidated and the stockholders reincorporated with the new assets.²⁸ The courts analyzed the transactions in the spirit of *Gregory v. Helvering*,²⁹ and by the use of the "step-transaction" doctrine³⁰ looked solely to the net effect in order to determine the tax consequences. Under this approach deviations from the precise statutory language were not controlling on the Commissioner.

Section 112(b)(3) of the 1939 Code³¹ required an exchange of stock, but the courts found that this, in substance, had been accomplished when the old stock was surrendered to the old corporation and the new stock was issued directly by the new corporation to the stockholders.³² Although the Code also required a transfer of assets from the old corporation to the new,³³ the fact that the assets went from the old corporation to the stockholders to the new corporation did not affect the result.³⁴

This is not to say that the Commissioner was without difficulties. He was never able to persuade the courts to waive the control requirements of section 112(g)(1)(D).³⁵ Moreover, notwithstanding the

26. *E.g.*, *Becher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955), *aff'g* 22 T.C. 932 (1954); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948).

27. *E.g.*, *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956), *aff'g* 23 T.C. 196 (1954); *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956), *rev'g on other grounds*, 22 T.C. 1220 (1954).

28. *E.g.*, *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945).

29. 293 U.S. 465 (1935). The taxpayer owned all of the shares of corporation *A*, which owned 1000 shares of corporation *B*. If *A* had distributed the shares of *B* to taxpayer, the taxpayer would have received an ordinary dividend. Instead, taxpayer created corporation *C*, *A* transferred its *B* corporation shares to *C*, the shares of *C* were issued to taxpayer, and then taxpayer liquidated *C*, receiving the *B* corporation shares. Although each step fit within the non-recognition provisions, dividend treatment was imposed on the theory that the transfers lacked a business purpose, and that there was one complete plan — *A*'s distribution of *B* corporation's shares to the taxpayer. The spirit of this case is that "substance" will prevail over "form." However, given formal compliance with the reorganization provisions, the absence of a corporate business purpose will not prevent the Commissioner from imposing these provisions on a series of transactions in order to tax the boot as a dividend. *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948).

30. *See pp. 523-25 infra.*

31. Int. Rev. Code of 1939, ch. 1, § 112(b)(3) (now INT. REV. CODE OF 1954, § 354).

32. *E.g.*, *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940), *aff'g* 39 B.T.A. 172 (1939); *Morley Cypress Trust*, Schedule "B," 3 T.C. 84 (1944).

33. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D). This section should be compared with section 368(a)(1)(D) of the current Code.

34. *E.g.*, *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945). *See also* *Bard-Parker Co. v. Commissioner*, 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955) (from old corporation to directors to new corporation).

35. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(D). Control was defined in Int. Rev. Code of 1939 ch. 1, § 112(h), (now INT. REV. CODE OF 1954, § 368(c)) to be the ownership of stock possessing at least 80 per centum of the total combined voting

fact that the courts had concluded that a liquidation could be part of a reorganization,³⁶ they did not always reach this result. For example, in *United States v. Arcade Co.*,³⁷ the old corporation was completely liquidated and the assets were transferred to a trustee for the benefit of the shareholders. Shortly thereafter, the trustee transferred the assets to a new corporation in which the shareholders had proportional interests similar to the old. The court held that there was no reorganization because the formation of the new corporation was not part of the plan of liquidation of the old. The court appeared to be impressed by the fact that the old corporation could not transfer assets to the new since it was liquidated before the new corporation was formed, that there was no agreement between the old and new corporations, and that the shareholders had no contractual obligation to form a new corporation or to transfer the assets from the old to the new. Although there are some cases³⁸ consistent with *Arcade*, such a segmentation no longer appears to be of any significance.³⁹ Nonetheless, it is this problem of determining which parts of a series of transactions to group together that is the core of the difference between the *Gallagher* and *Davant* approaches.

The 1954 Code did not change the definitions of (E) and (F) reorganizations, but by restricting the definition of the (D) reorganization through the addition of the requirement that securities be distributed pursuant to a section 354, 355, or 356 transaction as part of the plan of reorganization, it did create new problems. Section 356 is the boot provision and section 355 covers spin-offs and related transactions. Section 354(a)(1) provides for non-recognition of gain when stocks or securities are exchanged, but section 354(b) requires that the transferee receive "substantially all" of the "assets" of the transferor and that the stock, securities, and other properties received by the transferor be distributed to its shareholders.

The Commissioner has had excellent success in coping with the new problems. He has successfully argued that the phrase "substantially all of the assets" in section 354(b)(1)(A) is similar to "sub-

power of all classes of stock entitled to vote and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." The Commissioner tried to avoid the 80% "control" test in only one case, and he lost. *Austin Transit, Inc.*, 20 T.C. 849 (1953), *acquiesced in*, 1954-1 CUM. BULL. 3.

36. *E.g.*, *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949), *aff'g* 10 T.C. 1080 (1948); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947), *aff'g* 5 T.C. 665 (1945).

37. 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953).

38. *E.g.*, *Hendricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943); *Charles R. Mathis, Jr.*, 19 T.C. 1123 (1953) (where the liquidation successfully broke the series of steps on the ground that the reincorporation was not part of the plan to liquidate the old corporation).

39. See cases cited note 36 *supra*.

stantially all of the properties" in section 368(a)(1)(C), and, therefore, it means substantially all of the *operating* assets.⁴⁰ Although a (D) reorganization requires stock of the transferee to be distributed, and section 354(a)(1) requires an "exchange" of stock or securities, the courts recently have held that there need be no distribution, exchange, or issuance of stock from the new corporation where it would be a meaningless gesture.⁴¹

Although there has been little hesitation to interpret the Code liberally in order to find "substantially all" and "exchanges" and "distributions," there has been great reluctance to look through transactions to find reorganizations in the *Gallagher* type of situation. Where a group of shareholders is in actual control of a corporation, they can use this control to avoid taxes just as easily with 79% control as with 81%. In such a situation the 80% control test seems as meaningless as does the requirement of an "exchange." One explanation for the difference is that the result when there is, for example, no distribution of stock is, in effect, identical with the result which would be obtained if there had been a distribution, but in the *Gallagher* case, the result still left the continuing shareholders with less than 80% control. A system of taxation which requires identical tax treatment for a given result, regardless of how it is achieved, is not an irrational system. However, once that system establishes the statutory criteria for that result, it would appear that these criteria must be met unless the failure to do so does not result in undermining the criteria. Otherwise, the criteria become meaningless.

*David T. Grubbs*⁴² illustrates this liberal interpretation when the result is within the intended scope of the Code. As in *Gallagher*, shareholders of an existing corporation formed a new one to carry on the business of the old. The old corporation sold its assets to the new

40. *Reef Corp. v. Commissioner*, 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), *rev'g in part*, 24 CCH Tax Ct. Mem. 379 (1965); *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967), *aff'g* 42 T.C. 558 (1964); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966); *James Armour, Inc.*, 43 T.C. 295 (1964). The recent cases considering the "substantially all of the properties" requirement of section 368(a)(1)(C) are, for the most part, consistent with the "operating asset" concept for (D). See Lane, *The Reincorporation Game: Have the Ground Rules Really Changed?*, 77 HARV. L. REV. 1218, 1249-53 (1964) and the cases cited therein.

The theory behind the "operating asset" concept is that: since a corporation can declare a cash dividend whenever it wishes, doing so in conjunction with a reorganization should not prevent the application of the reorganization provisions of the Code. The cases, however, reveal confusion as to the meaning of "operating asset."

41. *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967); *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); *Commissioner v. Morgan*, 288 F.2d 676 (3d Cir. 1961), *cert. denied*, 368 U.S. 836 (1962). The premise here is that if the same shareholders own shares in corporations *A* and *B*, in identical proportions, and *A* transfers its assets to *B*, it is a meaningless gesture, in this context, for *B* to issue more shares.

corporation at book value, and the old corporation then made distributions which its shareholders claimed were entitled to capital gains treatment, but which the Commissioner treated as dividends. Unlike *Gallagher*, however, the control requirements *were* satisfied and the old corporation was *not* liquidated. Rather, it redeemed the shares of all but one of its shareholders, including those of Grubbs. The remaining shareholder then used the old corporation for a new line of business activity. The court, not unsurprisingly, found a (D) reorganization. However, in order to satisfy section 354(b)(1)(B), which is required for a (D) reorganization under section 368(a)(1)-(D), it must be found that "the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization." Not only did the old corporation not receive any stocks or securities, it did not distribute all of its other property. Nonetheless, the court held that this provision of the Code was complied with because the remaining shareholder, in effect, received his share but chose to leave it in the corporate shell. Hence, one can expect the courts in the future to utilize a similarly liberal construction of the Code where the net effect is the same and where requiring literal compliance would be a meaningless gesture. It should be noted, however, that such courts neither recast the transaction into another mold nor waive the effect of any requirement. Rather, they judicially supply steps in the transaction created by the parties, the omission of which are too insubstantial to warrant a different tax treatment.

B. Analytical Problems

Although *Davant* posed problems different from *Gallagher*, its rationale in finding an (F) reorganization merits close scrutiny. The court found that "[t]hree distinct and separate things occurred":⁴³ \$700,000 in Water's earnings and profits went to the shareholders by way of Warehouse; \$200,000 in Warehouse's earnings and profits were distributed to the shareholders; and then Warehouse's operating assets were combined with Water's. The court found that the only legitimate business purpose in the whole transaction was the elimination of Warehouse's corporate shell. The other two transactions were not necessary to accomplish this, and it "is apparent that no functional relationship exists between either the \$200,000 coming to petitioners from Warehouse or the \$700,000 coming to petitioners from Water and the transfer of Warehouse's assets to Water."⁴⁴

43. 366 F.2d at 882.

The taxpayers contended that since the reorganization sections were not literally satisfied there was a complete liquidation. The court correctly pointed out that the capital gains provisions of the liquidation sections were not intended by Congress to be a vehicle for distributing earnings when followed immediately by a reincorporation of the operating assets. The court then reasoned that since it cannot be a liquidation, it must be a reorganization, this being the converse of the taxpayers' argument. In finding that there was no liquidation, the court said that, for the purpose of determining whether section 331 was applicable, it viewed the plan as a whole to the extent that the parts were functionally related. The substance of the court's reasoning seems to be that since there was a continuity of the business activities and since the distribution can be ignored, there was, in substance, no liquidation. The court held that there was an (F) reorganization. After deferential reference to *Helvering v. Southwest Consol. Corp.*,⁴⁵ the court concluded that the merger of the assets was a mere change in form because it was immaterial which corporation held the assets.

The court departed from precedent not only in using an (F) theory where the liquid assets were distributed, but also in using it where the second corporation had a separate existence with its own assets and business. In other words, by treating the transfer of assets to Water as a separate transaction, the court found that there was "a mere change in identity, form, or place of organization, however effected."⁴⁶ The court construed the (F) definition in the disjunctive, and interpreted the word "form" to mean a change in form as opposed to a change in substance.⁴⁷

What constitutes a change in substance? Was the court there referring to *Southwest*? Would a shift in the proportionate interests of the shareholders be a change in substance? This question was subsequently answered in the negative by the same three judge court, with one judge dissenting this time, in *Reef Corp. v. Commissioner*.⁴⁸ In short, the old corporation transferred its assets to a new corporation and then liquidated, leaving 52% of the old shareholders owning 100% of the stock in the new corporation. The questions litigated included whether the new corporation, Reef Corporation, was entitled to a

45. 315 U.S. 194 (1942). *Southwest* involved a corporation which defaulted on its debts and was forced into a state receivership proceeding. The corporation was reorganized so that the creditors received most of the stock. The Court held that because of the shift in proprietary interest, there was no (F) reorganization. *Id.* at 202-03. The ramifications of this decision are explored at pp. 502-04 *infra*.

46. Section 368 (a) (1) (F).

47. 366 F.2d at 884.

48. 368 F.2d 125 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967), *rev'g in part*, 24 CCH Tax Ct. Mem. 379 (1965). Both *Reef* and *Davant* were argued on the same day by the same counsel before Judges Rives, Bell and Fulton. In fact, the briefs

stepped-up basis for depreciation purposes⁴⁹ and whether, under section 381, one or two tax returns were due. The transactions involved a strawman, as did *Davant*, and as in *Davant*, the court ignored the strawman and found a (D) reorganization.

Though this resolved the basis question, it did not answer the section 381 question involving the tax return issue. The Government's argument on section 381 necessarily rested on classifying the transaction as an (F) reorganization,⁵⁰ and the Government suggested that the transaction be viewed as an unrelated redemption followed by an (F) reorganization. The Tax Court refused to separate the transaction and then refused to apply (F) because of the shift in proprietary interests, citing *Southwest*, *Gallagher* and *Estate of James F. Suter*.⁵¹

The Fifth Circuit reversed the Tax Court on this issue, with Judge Bell dissenting. The court said that *Southwest*⁵² no longer applies because the 1954 Code completely reversed the 1939 Code.⁵³ The court held that, in substance, there were two "functionally unrelated" events: 48% of the stock was redeemed, and Old Reef became New Reef. Either step could have been taken without the other, and complete redemptions, the court said, have nothing to do with a reorganization.⁵⁴ In the name of congressional intent, the court revealed its test: "The test of whether events should be viewed separately or together as part of a single plan is not temporal but is functional."⁵⁵ Hence, the court concluded, the redemption is to be treated under section 302 and the rest of the transaction is clearly an (F) reorganization although it is also a (D) reorganization. Referring to section 381, the court said:

If a corporation did no more than completely redeem the stock interest belonging to 48% of its shareholders, it could not under the Code make wholesale accounting method changes. Like-

49. Section 362(b) caused the issue to center on whether there was a reorganization.

50. The effect of section 381(b)(1) is that only in an (F) reorganization is one tax return to be filed by the two corporate entities.

51. 29 T.C. 244 (1957) (finding no (F) reorganization on the ground that the steps could not be artificially segmented but must be viewed as one transaction).

52. See pp. 502-04 *infra*.

53. 368 F.2d at 134. The court ignored the fact that the wording of (F) has been in the tax laws since 1921. In 1954, the House version of the Code, H.R. 8300, 83d Cong., 2d Sess. (1954), omitted (F), perhaps because the draftsmen believed it was meaningless. Cf. R. PAUL, *Reorganizations*, in *STUDIES IN FEDERAL TAXATION* 3, 82 (3d Series 1940). In conference, however, (F) was put back in, without explanation. This hardly indicates that Congress intended to change the meaning of (F).

54. The court begs the question. In fact, there was no redemption. Rather, the transaction fell within the liquidation-reincorporation pattern and the real question was whether, under the facts, the transaction fit within the reorganization provisions. It would seem unsound to ground a decision on a distinction wrought by recasting and labelling a transaction so as to create the very distinction the court purports to find.

55. 368 F.2d at 134. The court cited *Davant* and *Bazley v. Commissioner*, 331

wise, if a corporation did no more than change its name and state of incorporation, it could not under the Code make wholesale accounting method changes. Combining these two events, neither of which would be sufficient alone, will not permit a corporation to make wholesale accounting method changes.⁵⁶

Granted that one's sense of fairness is not offended by the court's result, the method used to reach the result is untenable. The only limit suggested by the *Reef* court on its doctrines would be "if the change in proprietary interests were to new persons and less than 50% of the former stockholders' interest in the old corporation remained in the new corporation."⁵⁷ This, the court said, would more closely resemble a sale of assets to a new corporation.

Judge Bell in his dissent argued that (F) was properly applied in *Davant* where assets were shifted between corporations with identical shareholders, but cannot be applied where there is a shift of proprietary interests. Judge Bell also felt that *Southwest* had not been drained of its vitality by the passage of the 1954 Code.

Gallagher, then, under the rationale of the Fifth Circuit, comes within the (F) reorganization provision. The transaction, the court might argue, can be viewed as three functionally unrelated events: a redemption of 38.05% of the stock; a switch from a Delaware corporation to a California corporation; and a sale of 27.33% of the new corporation's stock to outsiders. Since any one of the three could have been done without the other two, the Fifth Circuit would treat this as three taxable events. Hence, the middle transaction would be an (F) reorganization and money received by the active shareholders would be taxable as a dividend under section 301 since there was no actual redemption of active shareholders which could qualify under section 302.

It is clear that the Commissioner is seeking to avoid the 80% control test of (D) by segmenting transactions and fitting them into the ambit of (F). Can transactions be segmented and recast? Is it proper, or at least meaningful, to use (F) reorganizations where the net result is a shift in proprietary interests or the merger of one active corporation into another? It is submitted that the use of the (F) reorganization in *Gallagher* would be improper and that the "functionally unrelated" mechanism of segmenting transactions is unfounded. It will be necessary to analyze the history of the (F) reorganization provision and its relation to other Code sections in order to determine whether this conclusion is proper.

III. THE (F) REORGANIZATION IN USE

A. *Before Gallagher*

The history of section 368(a)(1)(F) may be said to begin with the Revenue Act of 1918 which merely provided for non-recognition of gain on exchanges of stock or securities "in connection with the reorganization, merger, or consolidation of a corporation."⁵⁸ The terms "reorganization, merger, or consolidation" were not defined until 1921, when it was provided that:

The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected) . . .⁵⁹

This provision not only gave some substance to "merger or consolidation" but also added the language presently found in section 368(a)(1)(F).

Most probably, the statute was intended to be read and interpreted literally. The original House version of the 1921 Act had merely amplified the 1918 Act slightly and provided that the term "reorganization:" "includes a merger, consolidation (however effected), recapitalization, or a mere change in identity, form, or place of organization of a corporation. . . ."⁶⁰ Thus, the only element of the Act which apparently was not clear and required some clarification was the use of the terms "merger or consolidation" and this was remedied by inserting the lengthy parenthetical definition for the phrase "however effected." This intendment of literal construction was reflected in the judicial hostility to any broadening of the concept of "reorganization."⁶¹

In light of this context, it is suggested that the fairest interpretation to be given to the language which was to become section 368(a)(1)(F) is a literal one. In other words, the 1921 Act envisioned three types of transactions. The Act provided for a reshuffling

58. Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060.

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

60. H.R. 8245, 67th Cong., 1st Sess. § 202(d)(2) (1921).

61. Compare *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933), with *Pinellas Ice & Cold Storage Co. v. Commissioner*, 288 U.S. 188 (1933), and *W. J. Gallagher & Co. v. Commissioner*, 287 U.S. 462 (1933).

of interests involving more than one corporation,⁶² rearrangements within one corporation,⁶³ and rearrangements within one corporation which may, as a procedural matter, involve another corporate entity, but which, in substance, involve no changes in the corporation's business or stockholders.⁶⁴

The pre-1954 cases involving (F) reorganizations certainly appear to bear this out. In *Ahles Realty Corp. v. Commissioner*,⁶⁵ the old corporation exchanged all of its capital stock for all of the stock and debenture bonds of a new corporation. On the same day, the new corporation dissolved the old, thereby acquiring the assets and liabilities of the old corporation. The court held, without discussing the meaning of the (F) provision, that although this was not a common law merger, it did comply with the (F) definition.⁶⁶ Similarly, in *George Whittel & Co.*,⁶⁷ new corporation *A*, a Nevada corporation, in 1929, exchanged all of its stock with the sole stockholder of old corporation *B* for all of the stock of corporation *B*, a California corporation. Corporation *A* then acquired all of corporation *B*'s assets and liabilities and *B* was dissolved. The Board held that the plan was designed to change the state of incorporation and was precisely within the (F) language. Many of the early cases were not models of clarity. In some, the facts and the language of the courts suggest an (F) reorganization, but the courts, although finding a reorganization, fail to cite a particular part of the reorganization section.⁶⁸ In other cases, confused judges apparently failed to read carefully.⁶⁹

Just as the early cases did not suggest a broad scope for (F), the early rulings revealed the same tendency. Hence, (F) reorganizations were found only in the rather clear situations where a corporate charter with a limited life was renewed,⁷⁰ where a corporation trans-

62. This is provided for in the language prior to the close of the parenthesis in the Revenue Act of 1921, ch. 136, § 202(c) (2), 42 Stat. 230, quoted at note 59 *supra*.

63. This is a recapitalization, now section 368(a) (1) (E).

64. This is the "mere change in identity, form, or place of organization (however effected)," now section 368(a) (1) (F).

65. 71 F.2d 150 (2d Cir.), *cert. denied*, 293 U.S. 611 (1934).

66. *Id.* at 151.

67. 34 B.T.A. 1070 (1936).

68. *E.g.*, *Union Bleachery v. United States*, 73 F. Supp. 496, 501 (W.D.S.C. 1947), *aff'd*, 176 F.2d 517, 518 (4th Cir. 1949), *cert. denied*, 339 U.S. 964 (1950); *Mente & Co.*, 24 B.T.A. 401, 404-05 (1931).

69. In *San Joaquin Fruit & Inv. Co. v. Commissioner*, 77 F.2d 723 (9th Cir. 1935), *rev'd on other grounds*, 297 U.S. 496 (1936), Judge Wilbur said that in the case below, 28 B.T.A. 395 (1933), the Board had held that when a new corporation acquires all of the assets of its predecessor for stock and the shareholders of the predecessor own only 83% of the new stock, there is an (F) reorganization. The Board said quite clearly, however, *only* that the transaction was a reorganization, and fit within the definition section of the Revenue Act of 1924, ch. 234, § 203(h) (1), 43 Stat. 257 (now INT. REV. CODE OF 1954, § 368(a) (1)). The Board did not say that there was an (F) reorganization.

70. Rev. Rul. 54-269, 1954-2 C.B. BULL. 174, O.D. 930, 41 COM. BULL. 404 (1921).

ferred its principal office from one county to another and in so doing surrendered its old charter for a new one,⁷¹ where a federal savings and loan association converted itself into a state building and loan association,⁷² and where a joint stock company was converted into a corporation with the par values of the stock being no greater in the new corporation than in the old company.⁷³ One commentator, in discussing the early use of (F), believed that the section was so little relied upon by taxpayers that "this part of the statute has indeed perished through lack of use."⁷⁴

If the (F) language was designed to accomplish considerably more than the result reached in cases like *Ahles* and *Whittel*, it is certainly strange that the definitional sections of the revenue acts of those years also included mergers, recapitalizations, consolidations, stock for stock exchanges, and stock for asset exchanges. This is not to say that no overlap was intended. Certainly, a "mere change" transaction can be accomplished within any part of the Revenue Act of 1921.⁷⁵ On the other hand, to prevent the (F) language from being nugatory, a construction should be followed under which the language will mean that there must be a mere change, but given such change, the manner by which it is consummated is irrelevant. Hence, no particular procedure is prescribed for the (F) "changes" because despite such "changes" there is still complete continuity of the business, its activities, and its stockholders. Such a construction would be consistent with the early cases and rulings.

This analysis finds considerable support in the landmark case of *Helvering v. Southwest Consol. Corp.*⁷⁶ In that case, the old corporation was in default on its debts and, by 1932, was under the control of a creditors' committee. Pursuant to state receivership proceedings, a new corporation was formed, and the assets were transferred to the committee by purchase at the foreclosure sale. Almost all of the new common stock went to the old bondholders, the rest of the common and all of the Class A stock purchase warrants went to the unsecured creditors, and all of the Class B stock purchase warrants went to the old preferred and common shareholders. Fifteen per cent of the bondholders were paid off in cash.

71. I.T. 1152, I-1 CUM. BULL. 32 (1922). See also Rev. Rul. 66-171, 1966-1 CUM. BULL. 181.

72. Rev. Rul. 54-193, 1954-1 CUM. BULL. 106.

73. O.D. 1051, 5 CUM. BULL. 58 (1921).

74. R. PAUL, *Reorganizations*, in *STUDIES IN FEDERAL TAXATION* 3, 82 (3d Series 1940). Cf. B. BITTKER & J. EUSTICE, *FEDERAL TAXATION OF CORPORATIONS AND SHAREHOLDERS* § 12.17, at 548 (2d ed. 1966).

75. Revenue Act of 1921, ch. 136, § 202(c) (2), 42 Stat. 230. See text of statute

76. 315 U.S. 194 (1942).

Among many other things, Justice Douglas held, referring to the (F) language,⁷⁷ that "a transaction which shifts the ownership of the proprietary interest in a corporation is hardly 'a mere change in identity, form, or place of organization' within the meaning of clause E [now (F)]."⁷⁸ This sentence appears at first to have little meaning. On its face it means that any shift in proprietary interest precludes an (F) reorganization, and it has been so interpreted.⁷⁹ Does it mean less? In a companion case, *Helvering v. Alabama Asphaltic Limestone Co.*,⁸⁰ Justice Douglas, again writing for the Court, held that where, pursuant to a bankruptcy reorganization, all the stock of the new corporation went solely to the creditors of the old, the continuity of interest test⁸¹ was satisfied and there was a reorganization within section 112(i)(1) of the Revenue Act of 1928.⁸² He said that the reorganization did not shift the equity in the corporation from shareholders to creditors, but that once the creditors had enforced their claims, they were the equity owners.⁸³ Hence, there was complete continuity of interest. Non-assenting creditors were paid off in cash.

In *Southwest*, Justice Douglas had specifically indicated that but for the changes between the 1928 and 1934 Revenue Acts,⁸⁴ *Alabama Asphaltic* would control.⁸⁵ If so, then the only shift of proprietary interests in *Southwest* was either that the common and preferred stockholders of the old corporation were given stock warrants in the new corporation or that 15% of the bondholders were redeemed. If the old stockholders' receipt of warrants in the new corporation constituted the shift in proprietary interests, then *Southwest* would appear to have been wrongly decided. It is difficult to see how the right

77. The specific statute involved was the Revenue Act of 1934, ch. 277, § 112(g)(1)(E), 48 Stat. 705 (now INT. REV. CODE OF 1954, § 368(a)(1)(F)).

78. 315 U.S. at 202-03.

79. See *Cushman Motor Works v. Commissioner*, 130 F.2d 977, 981-82 (8th Cir. 1942), cert. denied, 318 U.S. 756 (1943); *Estate of James F. Suter*, 29 T.C. 244, 258 (1957); *Stollberg Hardware Co.*, 46 B.T.A. 788 (1942).

80. 315 U.S. 179 (1942).

81. See *LeTulle v. Scofield*, 308 U.S. 415 (1940), aff'g 103 F.2d 20 (5th Cir. 1939); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933), aff'g 57 F.2d 188 (5th Cir. 1932). The test is a judicial requisite for any reorganization and it requires that the equitable owners of the old business continue to have a substantial equitable interest in the business of the new corporation. The test would be met by the old shareholders receiving all of the shares of the new corporation, but would not be met if all of the old shareholders received only cash.

82. Revenue Act of 1928, ch. 852, § 112(i)(1), 45 Stat. 818 (now INT. REV. CODE OF 1954, § 368(a)(1)).

83. 315 U.S. at 183.

84. The Revenue Act of 1934, ch. 277, § 112(g)(1), 48 Stat. 705, added the requirement that the new corporation acquire the stock of the old "solely for all or a part of its [that is, the new corporation's] voting stock." The Supreme Court read this requirement of "solely" literally and held that since the new corporation paid some debts of the old in cash and also issued warrants, the "solely" test was not met.

85. 315 U.S. 194, 198, 202 (1942).

to buy an equity interest is either the same as having one or is, in itself, any sort of equity interest.⁸⁶ The warrant holder does not vote nor does he get dividends. Thus, the old stockholders did not have a proprietary interest in the new corporation, nor, under the doctrine of *Alabama Asphaltic*, did they have a proprietary interest in the old corporation. However, if the shift in proprietary interests in *Southwest* was that 15% of the bondholders were redeemed, the Supreme Court must have construed (F) to require virtually a 100% continuity in proprietary interests. At a minimum, the Court held that an 85% continuity of stockholder interest is insufficient to qualify as an (F) reorganization.

It would seem fair to conclude that any construction of section 368(a)(1)(F) which allows for its application in situations where there is any change in proprietary interests or any change in the total assets and operations of a corporation finds no support in the language, holdings, or theories underlying the early cases and rulings.⁸⁷

B. (F) In Other Parts of the Code

1. *Section 381.* — Section 381 provides for the carryover of earnings and losses in certain transactions. Section 381(b)(1) provides that in (F) reorganizations there shall be only one taxable year for both corporations, not a partial year for before and a partial year for after the reorganization. The *Reef* court was influenced by this restriction and therefore strained to find an (F) reorganization. Classifying a reorganization as (F) will, under section 381(b)(1), prevent the corporation from claiming two surtax exemptions under section 11(d). The *Reef* court evidenced a belief that section 381(b) treated (D) reorganizations more liberally than (F) reorganizations. However, the court apparently overlooked section 381(b)(3) which allows losses to be carried back to pre-reorganization years *only* in the case of an (F) reorganization.

The limits on loss carryovers and carrybacks⁸⁸ have had a tortured judicial career and did not emerge into statutory form until the 1954 Code. The Revenue Act of 1921 provided, in section 204(b), that if any taxpayer sustains a loss for the year, the taxpayer may carry it

86. See *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 200-01 (1942).

87. "The provision rendering a change in identity, form, or place of organization a 'reorganization' remains unchanged [in the 1954 Code]. This provision has always been rather obscure, and its re-enactment [in the 1954 Code] furnishes no clarification as to its content." Cohen, Silverman, Surrey, Tarleau, & Warren, *The Internal Revenue Code of 1954: Corporate Distributions, Organizations, and Reorganizations*, 68 HARV. L. REV. 393, 420 (1955).

88. For a brief survey of carryovers and carrybacks see Pennell, *Does the Libson Shift Doctrine Still Apply?*, 23 J. TAXATION 336 (1966).

forward to the next year.⁸⁹ In *New Colonial Ice Co. v. Helvering*,⁹⁰ the Supreme Court held that where in order to overcome financial difficulties a new corporation took over all of the assets, liabilities, and business activities of another corporation, had substantially the same capital structure, had the same shareholders in the same proportions, and had a continuity of business, there would nonetheless be no carry-over because two entities were involved and therefore the taxpayer claiming the deduction was not the same taxpayer as the one who incurred it. Although subsequent cases alleviated this burden somewhat in the case of mergers, the approaches were nonetheless very restrictive and the rationales very unclear.⁹¹

In *Newmarket Mfg. Co. v. United States*,⁹² however, a meaningful result was forthcoming. A Massachusetts corporation created a Delaware subsidiary and merged into it for the sole purpose of changing the state of incorporation. There were no changes in the corporation or shareholdings other than this change in the place of incorporation. The Commissioner denied a carryback on the theory that the two corporations were not the same "taxpayer."⁹³ The court said:

When, as here, everything in the business remains the same, except for the change of corporate domicile from Massachusetts to Delaware, . . . there is no more reason why the Congress should choose to attach crucial significance to a mere change of corporate domicile than it would to a change of an individual taxpayer's domicile from Massachusetts to Delaware.⁹⁴

The court went on to state that the 1954 Code now explicitly provides for this result. Nevertheless, no case granting the carryback privilege has been found where the corporate reorganization could not be labelled as a mere change within the *Southwest* doctrine.

Although the regulations under section 381 shed no light on the meaning of 368(a)(1)(F), the Revenue Rulings do. Revenue Ruling 57-276⁹⁵ holds that where a corporation changes its place of incorporation by creating a subsidiary in another state and merging into it under state law, the reorganization is both an (A) and an (F) reorganization and, for purposes of section 381, will be deemed an (F). Revenue Ruling 58-422⁹⁶ expands this and holds that where a corpora-

89. Revenue Act of 1921, ch. 136, § 204(b), 42 Stat. 231.

90. 292 U.S. 435 (1934).

91. Compare *Stanton Brewery, Inc. v. Commissioner*, 176 F.2d 573 (2d Cir. 1949), with *E. & J. Gallo Winery v. Commissioner*, 227 F.2d 699 (9th Cir. 1955).

92. 233 F.2d 493 (1st Cir. 1956), cert. denied, 353 U.S. 983 (1957).

93. Section 122(b)(1)(B) of the 1939 Code is the section construed by the court. Int. Rev. Code of 1939, ch. 1, § 122(b)(1)(B).

94. 233 F.2d at 497.

95. 1957-1 CUM. BULL. 126.

tion with two subsidiaries creates a new subsidiary in another state and merges all of its assets into the new subsidiary, thereby resulting in only one corporation, there is also an (F) reorganization for purposes of section 381. The ruling points out that the old parent could have liquidated the subsidiaries under section 332 and then changed its place of incorporation and concludes that the tax results will not depend on whether the liquidation of the subsidiaries is done simultaneously with the reincorporation. The important reason for the result is that the "stockholders of the former parent had the same equity in the surviving corporation that they had in the three old corporations, inasmuch as all of the assets of the three transferor corporations were held by the surviving corporation."⁹⁷

Revenue Ruling 66-284,⁹⁸ the most recent ruling, is particularly illuminating. This ruling also involved a statutory merger into a new subsidiary to effect a change in the place of incorporation. In this situation, however, less than one per cent of the shareholders dissented and exercised their appraisal rights. Citing no authority save Revenue Ruling 58-422, the ruling states that:

The failure of dissenting shareholders owning a total of 1 per cent of the outstanding shares to participate in the plan of merger [is] . . . such a de minimis change in the corporation's shareholders and its assets as not to disqualify the merger as a reorganization under section 368(a)(1)(F) of the Code.⁹⁹

The manner in which (F) has been applied to carrybacks is inconsistent with the *Davant-Reef* doctrine, and, in fact, the recent cases have rejected such an approach.¹⁰⁰ The entire history of the carryback provision reflects a very restrictive approach, especially on the part of the Government, and the legislative history is entirely consistent with this.¹⁰¹ A broad conception of (F), as in *Davant-Reef*, would make the exception in section 381(b)(3) meaningless. Furthermore, there is no authority to suggest this result. Rather, the de minimis test of Revenue Ruling 66-284 is consistent with an interpretation of (F) which would require virtually a 100% continuity of the business, its total assets, and its shareholders. The ruling does not contemplate a

97. *Id.* at 146.

98. 1966-2 CUM. BULL. 115.

99. 1958-2 CUM. BULL. 145.

100. 1966-2 CUM. BULL. 115, 116. See *Associated Mach. Shop*, 48 T.C. 318 (1967); *Estate of Stauffer*, 48 T.C. 277 (1967).

101. The original House version of the 1954 Code simply provided that there would be no loss carrybacks after corporate reorganizations. H.R. 8300, 83d Cong., 2d Sess. § 381(b)(3) (1954). The Senate added the present exemption for (F) reorganizations. The report of the Committee on Finance to the Senate reveals no explanation for the addition. S. REP. NO. 1622, 83d Cong., 2d Sess. 276 (1954). The Conference report is silent also. One suspects that Congress had no intention of providing an exemption any broader than the narrow *Southwest* interpretation of (F).

consolidation of two functioning corporations, regardless of the identity of the shareholders, nor a shift in the proprietary holdings, and it is totally inconsistent with Revenue Ruling 61-156, which found an (F) reorganization even though the owners of the stock of the old corporation owned only 45% of the stock of the new corporation.¹⁰² Finally, considering the restrictive use of carrybacks which the Commissioner has long urged, one suspects that he would oppose an application of section 381(b)(3) to a *Gallagher* type of situation. Yet *Reef, Davant*, and Revenue Ruling 61-156 would seem to leave him little room for argument. As Judge Magruder said, "interpretative chickens may come home to roost at a time when the barnyard wears quite a different aspect."¹⁰³

2. *Section 1244.* — Ordinary, as opposed to capital, loss treatment for certain stock issued by small corporations is provided for in section 1244.¹⁰⁴ It was designed to encourage capital investment in small businesses by providing a favorable loss treatment for these risky investments.¹⁰⁵ In general, stock substituted for section 1244 stock is not entitled to similar benefits. However, section 1244(d)(2) and the regulations thereunder¹⁰⁶ provide for three exceptions: (1) stock dividends, (2) stock acquired in (E) reorganizations, and (3) stock acquired in (F) reorganizations. The legislative history does not explain these exceptions. The only rational interpretation is that the benefits of the section are to be restricted to the individual who makes the investment and to the very corporation in which he invests.¹⁰⁷ There have as yet been no cases or rulings on the use of (F) in section 1244.

The use of (F) in section 1244 is consistent with its use in section 381(b)(3), but, as in its use in section 381(b)(3), inconsistent with *Davant-Reef*.

3. *Section 4382.* — Section 4382 provides for exemptions from certain excise taxes, and section 4382(b)(1) provides that the taxes imposed by sections 4311, 4331, and 4361¹⁰⁸ shall not apply to

102. 1961-2 CUM. BULL. 62. See pp. 519-20 *infra*. It is amazing that the Internal Revenue Service was litigating *Reef* and *Davant* at the same time it was drafting Revenue Ruling 66-284. The only rational explanation is that the litigation and ruling departments are not functionally related.

103. *Portland Oil Co. v. Commissioner*, 109 F.2d 479, 488 (1st Cir.), *cert. denied*, 310 U.S. 650 (1940).

104. See generally Moore & Sorlien, *Adventures in Subchapter S and Section 1244*, 14 TAX L. REV. 453 (1959); Rubin, *Section 1244 and the Stylish Stout*, 12 TUL. TAX INST. 559 (1963).

105. H.R. REP. No. 2198, 85th Cong., 2d Sess. 2-3 (1958).

106. Treas. Reg. § 1.244(d)-3(a) (1960).

107. Rubin, *supra* note 104, at 567.

108. Sections 4311, 4321, and 4331 have been repealed as of January 1, 1966, and section 4361 has been repealed as of January 1, 1968. Excise Tax Reduction Act of 1965, Pub. L. No. 89-441, 411 (1965).

transactions which effectuate any plan of corporate reorganization or adjustment "whereby a mere change in identity, form, or place of organization is effected." This is the same language that appears in section 368(a)(1)(F) save for the omission of the last two words of (F), "however effected," and suggests that section 368(a)(1)(F) was in the draftsman's mind. It was the limited *Southwest* interpretation of (F) reorganizations that Congress believed it was enacting.¹⁰⁹ This also has been the interpretation of the Commissioner, and, in the one ruling on the exemption, it was held that where a corporation merges with its 95% owned subsidiary and the minority shareholders of the subsidiary thereby acquire 3% of the stock of the parent, the transaction does not qualify for the exemption. The exemption was held to be "not applicable to a change which involves any shift in ownership, because in any shift in ownership there is involved more than a mere change in identity, form, or place of organization."¹¹⁰

Cabot Corp. v. United States,¹¹¹ the first case involving the exemption, is indistinguishable on its facts from the revenue ruling. The court said that the fact that the corporation could have reincorporated first and then merged its subsidiary so as to avoid transfer taxes on the reincorporation was irrelevant and that, citing *Southwest*, the shift in ownership resulted in loss of the exemption.¹¹² The only other section 4382(b)(1)(D) case, *Columbia Gas, Inc. v. United States*,¹¹³ arose when the Cumberland and Allegheny Gas Company, a subsidiary of Columbia Gas System, Inc. and an operator of natural gas transmission and distribution facilities in West Virginia and in Maryland, decided to have separate corporate operations in each state. Therefore, it created a subsidiary, Columbia Gas of Maryland, and transferred its Maryland assets to the Maryland corporation. Maryland issued stock and notes to Columbia and Columbia cancelled stock and notes of Cumberland which it held. The result was a "split-off" with Columbia having two subsidiaries instead of one. The Internal Revenue Service ruled that this was a (D) reorganization.¹¹⁴ The court held that no section 4382(b)(1)(D) exemption was available.

109. [A] new exemption in the case of corporate reorganizations where the change is a mere change in identity, form, or place of organization, however effected. Such corporate reorganizations . . . presently are free of income tax. Reorganizations involving a mere change in identity, form, or place of organization, represent merely a formalistic change and do not involve any shifts in ownership.

S. REP. No. 2090, 85th Cong., 2d Sess. 61 (1958) (emphasis added).

110. Rev. Rul. 63-203, 1963-2 CUM. BULL. 580, 581.

111. 220 F. Supp. 261 (D. Mass. 1963), *aff'd per curiam*, 326 F.2d 753 (1st Cir. 1964).

112. Compare Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

113. 366 F.2d 991 (Ct. Cl. 1966).

114. See *Sullivan*, *supra* note 3, at sections 368(a)(1)(D) and 355.

Although there was 100% continuity of ultimate ownership, the mere change in the language of the (D) provision was not intended to include *divisive* reorganizations. The court believed that section 4382(b)(1)(D) is at least as narrow as section 368(a)(1)(F). However, in stating that (F) might be broader, it relied on Revenue Ruling 61-156¹¹⁵ and a misinterpretation of *San Joaquin Fruit & Inv. Co. v. Commissioner*.¹¹⁶ The dissent expressed the view that since there was a 100% continuity in ultimate stock ownership, section 4382(b)(1)(D) was actually satisfied.

Although section 4382(b)(1)(D) does not refer to section 368(a)(1)(F), it probably was meant to cover the same transactions. Granted that this intention could have been more clearly effectuated by merely referring to section 368(a)(1)(F), nonetheless, the similar wording in a part of the Code far removed from corporate reorganizations cannot be disregarded. The choice of words could hardly have been fortuitous and it is unreasonable to assume that the same formula would have different meanings. To have done so would have been less rational than using a phrase of art without reference to its antecedent.

Sections 381(b)(3), 1244(d)(2), and 4382(b)(1)(D) were all enacted decades after the original version of (F), and in each instance the context requires a narrow reading. One must assume that Congress was cognizant of what it was doing in each of these three sections, and that it therefore expected a narrow reading. Positing this reasoned formulation, to assume that Congress intended these sections to be inconsistent with section 368(a)(1)(F) is dubious. Similarly, to interpret section 368(a)(1)(F) inconsistently with sections 381, 1244, and 4382 is patently inappropriate.

It would seem fair to conclude that any construction of section 368(a)(1)(F) which allows for its application in situations where there is any change in proprietary interests or any change in the total assets and operations of a corporation, other than a de minimis change, can find no support in the language, holdings, or theories underlying the use of (F) in the other sections of the Code.

C. The Recent Reorganization Cases

In only two recent cases has the Tax Court found an (F) reorganization. In *Pridemark, Inc.*,¹¹⁷ Judge Pierce¹¹⁸ found that a corporation did not completely liquidate, but rather transferred sub-

115. 1961-2 CUM. BULL. 62. See pp. 519-20 *infra*.

116. 77 F.2d 723 (9th Cir. 1935), *rev'd on other grounds*, 297 U.S. 496 (1936), *modifying* 28 B.T.A. 395 (1933). See note 69 *supra*.

117. 42 T.C. 510 (1964), *rev'd on other grounds*, 345 F.2d 35 (4th Cir. 1965).

stantially all of its operating assets to a new corporation with substantially similar shareholders, and that there was a continuity of the business. Without resorting to either authority or explanations, he held that the "transactions *clearly* fall within both the letter and the intent of section 368(a)(1)(F). . . ." ¹¹⁹ On the basis of the prior analysis, however, it seems that the holding is incorrect in that it is inconsistent with the prior case law and revenue rulings.¹²⁰ Judge Pierce found an (F) reorganization, notwithstanding shifts in the proprietary interests, shifts in the operating assets, and an apparent lack of continuity of the business activity.

On appeal, the court of appeals did not reverse on the grounds that (F) was misapplied, but rather it interpreted the facts differently. The court found no intent to reincorporate at the time of the liquidation of the old corporation and no continuity in the business activity, and, therefore, had no occasion to apply the "step-transaction" theory¹²¹ or the reorganization sections. In dictum, however, it was suggested that an (F) reorganization might include a distribution of some of the liquid assets.¹²² The justification for this observation is not readily apparent. If a corporation wishes to change its state of incorporation it can do so by transferring all of its assets to a new corporation for the shares of the new corporation and then liquidating the old corporation. If, in the process, the old corporation retains some cash and

119. 42 T.C. at 532 (emphasis added).

120. The corporation had a net book value of \$411,328.90 and the shareholders received about \$392,000 in cash and in kind. Both the old and new corporations were sales agencies for prefabricated homes, but for different manufacturers. Although the new corporation received from the old corporation the lease for the home office, the name, and the trade slogan, the old corporation sold to the manufacturer, upon termination of the dealership contract, for \$174,866: customer lists, customers' contracts not yet begun (valued at \$134,400), ten sales offices in three states, goodwill, use of certain trade names, and the right to hire any and all of Pridemark's salesmen. Pridemark promised not to try to rehire the men for at least one year. Pridemark lost all of its sales force, and, at the time, intended to liquidate. The principal shareholder owned 80% of the common, all class B preferred, and none of the class A preferred of the old corporation, but only 61% of the common of the new corporation. Nine per cent of the stock in the new corporation was owned by persons who were not shareholders of the old, one 5% shareholder of the old owned none of the new, and more than one-half of the old preferred shareholders did not continue in the new corporation. The new corporation was formed eight months after the sale of the old's assets, and a few months before signing a new dealership contract, because the principal shareholder was unsuccessful in other business endeavors.

It is difficult to understand how Judge Pierce ignored the fact that all of the salesmen of the old corporation had left. One wonders how he held that the new corporation had substantially all of the operating assets of the old. Judge Pierce's decision seems totally inconsistent with *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967), *aff'g* 42 T.C. 558 (1964). With reference to a corporation of consulting engineers, the court there said that "its most valuable asset consisted of its reputation and the pool of experienced employees which passed intact to Engineers. . . . Where a business is largely service oriented, as here, this item may well be the single most valuable asset." 363 F.2d at 268n.2. This statement appears to be equally applicable to Pridemark, Inc.

121. See pp. 523-25 *infra*.

122. See pp. 545-46 *infra*.

distributes it to its shareholders, then the transaction will fall within the framework of (D), thus obviating the need for (F). However, if the court was referring to a case where a corporation merely changes its name and, in so doing, causes all of its shareholders to surrender their old certificates for new ones, then, although there would be an (F) reorganization, it is hard to see how the distribution of cash could be held to be part of the "plan of reorganization." It is doubtful whether a decision to change the name of a corporation would be contingent on a distribution of cash. As such, the two elements of the transaction would seem not to be intended by the corporation to be dependent one upon the other. Under the "mutually interdependent" theory,¹²³ the two elements would be unrelated and the distribution could be taxed as a dividend under section 316. This does not make the distribution a part of the (F) reorganization.

In a recent case, *Dunlap & Associates, Inc.*,¹²⁴ the Tax Court found an (F) reorganization but did so under the more traditional notions of intent and "mutual interdependence."¹²⁵ The court refused to adopt a *Davant-Reef* approach on the basis that *Reef* was not controlling since it was factually distinguishable. Subsequently in *Associated Mach. Shop*¹²⁶ and *Estate of Stauffer*¹²⁷ the Tax Court, in marked contrast to the *Davant* court, held that an (F) reorganization must take place within a single corporation and can not involve the combination of two or more separate businesses.

The Commissioner has been even less successful in other recent cases. In *Hyman H. Berghash*,¹²⁸ the sole shareholder of a drugstore corporation felt compelled to sell a 50% interest to a key employee in order to retain his services. The employee paid \$25,000 for one-half of the shares of a new corporation, and the old corporation sold its assets, except cash, to the new corporation for the other one-half of the shares and a six per cent note with a face value of \$96,101.64. In liquidating, the old corporation distributed the shares, note, and \$49,313.17 in cash. The Tax Court held that this was not an (F) reorganization because the (F) reorganization "presumes that the surviving corporation is the same corporation as the predecessor in every respect, except for minor or technical differences [in other

123. The "mutually interdependent" theory has been stated as: "Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?" *American Bantam Car Co.*, 11 T.C. 397, 405 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950). This theory is discussed in detail at pp. 521-23 *infra*.

124. 47 T.C. 542 (1967).

125. See pp. 521-23 *infra*.

126. 48 T.C. 318 (1967).

127. 48 T.C. 277 (1967).

128. 437 U.S. 743 (1965), *aff'd*, 360 F.2d 257 (2d Cir. 1966).

words, the (F) reorganization is] only the simplest and least significant of corporate changes."¹²⁹ Since there was a shift in the proprietary interests, the court held that there was no (F) reorganization.

Either the Commissioner did not argue that the steps could be segmented or the Tax Court disagreed with the theory without opinion. In this instance such an argument would be tenuous because the *raison d'être* of the transaction was to bring in a new shareholder who could not afford a larger investment. Nonetheless, the old corporation *could* have created a class of preferred stock and distributed this stock as a dividend, thereby reducing the value of the common. *Gallagher* was used as authority for finding no (F) reorganization, and, as in *Gallagher*, the finding of a (D) reorganization was prevented by the 80% control requirement of section 368(a)(1)(D).

In *Book Prod. Indus. Inc.*,¹³⁰ the findings of the Tax Court were that a new corporation did not acquire substantially all of the operating assets of the old corporation and the notes of the new corporation that were held by the shareholder of the old corporation did not represent a continuing proprietary interest. Therefore, the court concluded that there was no (F) reorganization.

Finally, in *Turner Advertising of Ky., Inc.*,¹³¹ a case similar to *Gallagher*, a new corporation was created where 100% of the shareholders of the old corporation owned almost 49% of the shares of the new and the other 51% of the shares of the new corporation were in the hands of employees of the principal shareholder of the old corporation. The new corporation then bought all of the shares of the old for cash and notes, and, having done so, liquidated the old. The Government claimed that the sale of 51% of the shares of the new corporation should be disregarded as an unrelated transaction. The Tax Court could not "justify the inclusion of some and the exclusion of other essential steps."¹³² Rather, the court viewed the transaction as a whole, looked to the end result, and found no (D) reorganization because the control test was not satisfied, and no (F) reorganization because of the shift in proprietary interests.

D. A Definition for Section 368(a)(1)(F)

At the present time, the regulations contain no definition of the (F) reorganization. Nevertheless, a definition does emerge from an analysis of the early use of (F) and its present use in sections 381,

129. *Id.* at 752.

130. 24 CCH Tax Ct. Mem. 339 (1965).

131. 25 CCH Tax Ct. Mem. 532 (1966).

132. *Id.* at 536.

1244, and 4382. Such an examination indicates that an (F) reorganization requires a 100% continuity of shareholders in the same proportions and interests in the new corporation as in the old corporation, a 100% continuity of corporate assets, and a 100% continuity of corporate business activities. The only exceptions should be those adjustments in shareholdings and assets due to matters over which the corporation has no control, such as an exercise of appraisal rights by a small dissident minority, and such changes as modifications in the corporation's charter or certificate of incorporation. This definition thus describes a relationship between (1) a given group of people, (2) with a given group of assets, (3) in a given business activity, and (4) in a corporate entity. The synthesis of this approach is to suggest that the only meaningful purpose which can be ascribed to (F) is that if factors (1), (2), and (3) remain constant, then factor (4) can be changed in name, state of incorporation, or form,¹³³ without any tax consequences.

This definition would exclude *Gallagher* and *Reef* on the one hand, and *Davant* on the other. In the former cases, there were changes in proprietary interests, and in the latter case, there was a change in assets and business activity. Although the definition would not include a broad variety of cases, there is no evidence to suggest that it was ever intended to do so. There would not be a complete overlap with the other reorganization provisions because the definition includes, as none of the others do, such modifications within one corporation as a change of name where the old shares are exchanged for new ones. This definition also has the virtue of not being so inclusive as to render other parts of section 368(a)(1) meaningless, of being consistent with the use of (F) in other parts of the Code, and of being in accord with the interpretation of (F) prior to Revenue Ruling 61-156.¹³⁴

IV. SEPARATING THE TRANSACTIONS

In *Davant* and *Reef* it was argued that two transactions are "functionally unrelated," and must be treated separately for tax pur-

133. The meaning of the word "form" is not clear. Perhaps it was intended to cover a situation where a corporation amends its charter in order to increase the powers of the corporation. By itself, such an action would hardly appear to be a reorganization. However, if a corporation does change its charter *and* name, and the shareholders trade old shares for new ones, then the word "form" prevents a construction of the section which would exclude any corporation which did *more* than merely change its name.

134. 1961-2 CUM. BULL. 62. See pp. 519-20 *infra*. For an analysis of (F) that suggests a similar definition as that proposed see Comment, *(F) Reorganizations and Proposed Alternate Routes for Past Reorganization Not Operating Loss Carry-Over*, 1968-1 CB 408 (1968).
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poses, if one transaction could have been wholly accomplished independently of the other. Under this reasoning, it is irrelevant whether the parties would have done one without the other. The purpose of segmenting the transaction is to prevent tax avoidance. But, as valid as such a general purpose may be, it does not provide authority for a segmentation in all situations.

A. *The Commissioner's Weapons*

Before *Davant* and *Reef*, the Commissioner had three weapons he could use to advance the segmentation theory.

1. *The Cases* — Initially, reliance could be placed on some prior case law. In *Bazley v. Commissioner*,¹³⁵ the taxpayer and his wife owned all but one of the corporation's one thousand \$100 par value shares. The corporation then exchanged all of these shares for five thousand \$60 stated value, no par, new shares, and \$400,000 worth of debentures. The corporation had an earned surplus of \$855,783.82. The taxpayer argued that the transaction was a tax-free recapitalization, but the Commissioner contended that the recapitalization served no legitimate corporate business purpose and that the securities should be treated as a dividend. The Supreme Court concluded that the securities were taxable as a dividend and that the transaction as a whole was not a tax-free recapitalization.

There is language in the opinion which suggests that there was a recapitalization. However, since there was no legitimate non-tax reason for the issuance of the securities and because they could have been issued independently of a recapitalization, they were treated separately from any recapitalization.¹³⁶ On the other hand, there is language which suggests that in this type of situation there is no recapitalization at all, and each part of the transaction will be taxed separately.¹³⁷ It is not clear whether Justice Frankfurter viewed the new stock as having been received as part of a reorganization. In any event, the Court did reveal a desire to prevent the creation of a loophole which would allow shareholders to receive corporate debt instru-

135. 331 U.S. 737 (1947).

136. What have we here? No doubt, if the Bazley corporation had issued the debentures . . . without any recapitalization, it would have made a taxable distribution. Instead, those debentures were issued as part of a family arrangement, the only additional ingredient being an unrelated modification of the capital account.

Id. at 742.

137. "A 'reorganization' which is merely a vehicle, however elaborate or elegant, for conveying earnings from accumulations to the stockholders is not a reorganization under section 112. . . . And even if this transaction were deemed a reorganiza-

ments, taxable as a dividend under section 301, in the form of a tax-free recapitalization. Perhaps Justice Frankfurter was unclear because he could have disposed of the case on grounds wholly unrelated to the question of whether the issuance of the securities was part of a recapitalization.¹³⁸ Nevertheless, if the case holds anything about segmenting transactions it is that just as steps cannot be separated to avoid taxes,¹³⁹ so they cannot always be combined to avoid taxes. As questionable as this may be, it is still far removed from recasting what was done to what could have been done.¹⁴⁰

Another case, *Bard-Parker Co. v. Commissioner*,¹⁴¹ involved a dispute over the basis of assets received from a predecessor corporation. The Tax Court held that the new corporation was created for the dual purpose of taking over the business of the old corporation and expanding it by the simultaneous acquisition of certain patents owned by one of the shareholders of the old corporation. The taxpayer argued in the court of appeals that the simultaneous transfer to the new company of both the assets of the old corporation and the patent rights of the shareholder must be viewed as one transaction and, as such, the transaction was outside the purview of section 112(b)(4) of the Revenue Act of 1928.¹⁴² In rejecting this argument, the court said:

There were two separate transfers which did not become transmuted into component steps of a single transfer merely because separate properties were transferred at the same time to one transferee. These two transactions were not . . . mere "procedural" steps towards the completion of one transaction. Nor were the two transfers, otherwise distinct, fused into one merely because

138. The bonds involved were 20 year debenture bonds, but were callable at the option of the corporation (completely controlled by the taxpayer) and were freely marketable. *Bazley v. Commissioner*, 155 F.2d 237 (3d Cir. 1946), *aff'g*, 4 T.C. 897 (1945). It has been long established that short term notes are to be treated like cash and not like securities. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). Bonds which are payable at the option of the bondholders seem more like cash than even short term notes. Hence, the bonds should not be considered as within Int. Rev. Code of 1939, ch.1, § 112(b)(3), but instead, subject to boot treatment under Int. Rev. Code of 1939, ch.1, § 112(c). The *Bazley* corporation had a sufficient earned surplus to cover the distribution and the facts do not reveal any inability of the corporation to raise the cash should the bonds be called. Under these circumstances, the so-called doctrine of *Commissioner v. Estate of Bedford*, 325 U.S. 283 (1945), would call for dividend treatment for the bonds. Mr. Justice Frankfurter wrote *Bazley* only two years after his opinion in *Bedford* and, from his language in *Bazley*, one senses that he was thinking of *Bedford* and was determined to tax as a dividend what he believed was essentially a dividend, regardless of the literal statutory language. Today, *Bazley* would come under section 356(d).

139. *See, e.g.*, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir.), *cert. denied*, 293 U.S. 611 (1934).

140. This is not to say that courts have never justified results in terms of what the taxpayer could have done.

141. 218 F.2d 52 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955), *aff'g* 18 T.C. 1255 (1952).

142. Revenue Act of 1928, ch. 852, § 112(b)(4), 45 Stat. 816.

the interested persons would not have entered into the arrangement unless it involved both transfers contemporaneously.¹⁴³

Judge Frank then went on to say that: "We do not hold that the dominant aim of the interested persons may never be controlling in this area. . . ."¹⁴⁴ No authority for these propositions is offered by the court, and the logic of the opinion is difficult to follow. It is not at all self-apparent that the two transfers were separate and unrelated.

2. *Legislative History.* — The Commissioner's second weapon in support of his "functionally unrelated" theory comes from the legislative history. The House version of the 1954 Code included a section¹⁴⁵ which would have covered the *Gallagher* situation. The Senate deleted this section without explanation, but in the conference report, the Managers of the House explained:

The House bill in section 357 contained a provision dealing with a device whereby it has been attempted to withdraw corporate earnings at capital gains rates by distributing all the assets of a corporation in complete liquidation and promptly reincorporating the business assets. This provision gave rise to certain technical problems and it has not been retained in the bill as recommended by the accompanying conference report. It is the belief of the managers on the part of the House that, at the present time, the possibility of tax avoidance in this area is not sufficiently serious

143. 218 F.2d at 57-58.

144. *Id.* at 58.

145. (a) GENERAL RULE. — In any case in which one or more individuals receives assets in a complete or partial liquidation as defined in section 336 from a corporation controlled by such individual or individuals and within 5 years from the date of the final distribution in such liquidation transfer more than 50 per cent of such assets (other than money and stock or securities (other than stock or securities representing an interest in the distributing corporation)) to one or more corporations controlled by one or more of such individuals in a transaction to which section 351 is applicable—

(1) the corporation to which any of such assets have been transferred shall be deemed to have received such assets from the liquidating corporation pursuant to a corporate acquisition of property within the meaning of section 359(c); and

(2) an amount equal to the fair market value of the assets received in liquidation not so transferred shall be deemed to have been received by the individuals in control of such other corporation or corporations as a distribution under section 352 pursuant to such corporate acquisition of property and such distribution shall be deemed to have occurred on the date the assets were transferred to such other corporation or corporations. For the purpose of this subsection one or more individuals shall be considered to be in control of a corporation if such individuals own directly or indirectly stock which represents at least 50 per cent of the total combined voting power of the outstanding stock of such corporation or at least 50 per cent of the total value of shares of all classes of stock of such corporation.

(b) TRANSFERS NOT IN AVOIDANCE OF TAX. — Subsection (a) shall not be applicable in any case in which it is established by the taxpayer that such transactions did not have as one of their principal purposes the avoidance of tax on corporate distributions of property under section 301.

(c) CONTRIBUTION OF OWNERSHIP. — For the purpose of this section in determining the ownership of stock and the receipt of assets, section 311 shall be applicable.

to require a special statutory provision. It is believed that this possibility can appropriately be disposed of by judicial decision or by regulation within the framework of the other provisions of the bill.¹⁴⁶

This statement suggests that the Commissioner now has authority to end all evils in this area in any way. However, the deletion of section 357 suggests that Congress did not intend to produce a result different from *Gallagher*. Seemingly, the most sensible interpretation of the two events would be to ignore them both, entirely. Omissions and general expectations are of little value in interpreting statutory language.

3. *Regulations and Rulings.* — The third weapon of the Commissioner has developed through self-serving regulations and rulings. There are but two regulations which give any support to the Commissioner's approach. The first is pursuant to section 331, and provides:

A liquidation which is followed by a transfer to another corporation of all or part of the assets of the liquidating corporation or which is preceded by such a transfer may . . . have the effect of the distribution of a dividend or of a transaction in which no loss is recognized and gain is recognized only to the extent of "other property." See sections 301 and 356.¹⁴⁷

This regulation has no apparent support in the cases or statutes, and it had no precedent in the regulations. If it refers to the reincorporation cases,¹⁴⁸ it fails to mention them, save the reference to section 356. Even if reliance is placed on cases outside the reorganization area, it constitutes a questionable interpretation of the word "complete" in the "complete liquidation" provision of section 331.¹⁴⁹ Section 331(a)(1) speaks of "complete liquidation of a corporation" and this is to be contrasted with "partial liquidation" in section 331(a)(2). The word "complete" connotes dissolution of the corporate shell, and has no obvious reference to the continuity of a business enterprise by a group of shareholders. Furthermore, it has been held that where a corporate entity is actually liquidated but the transaction is not a

146. H.R. REP. NO. 2543, 83d Cong., 2d Sess. 41 (1954).

147. Treas. Reg. § 1.331-1(c) (1955).

148. Cases cited notes 26, 27 & 28 *supra*.

149. *But see* Grubb, *Corporate Manipulations Under Subchapter C: Reincorporation-Liquidation*, 28 U. CIN. L. REV. 304 (1959); Rice, *When Is a Liquidation Not a Liquidation for Federal Tax Purposes?*, 8 STAN. L. REV. 208 (1956). "It may reasonably be argued as a matter of proper tax administration that where the participation in the liquidation is controlled by the same persons, the tax advantages arising from the liquidation should be denied them." *Id.* at 208.

complete liquidation, it must, then, be a reorganization.¹⁵⁰ This is the sensible statutory interpretation. The reorganization sections are designed to deal with situations where there is a continuity of shareholder interests in business enterprises and have been used where, as a step in the reorganization, a corporation is liquidated.¹⁵¹ Dividend treatment is defined in section 316 and results solely from a corporation-shareholder relationship. Where there is a liquidation, there can be a dividend only if there is some corporation to provide the relationship. To ignore the reorganization sections and find a dividend in a liquidation-reorganization situation would render sections 368, 354, and 356 nugatory in this area because all of the statutory requirements for a reorganization could be ignored. Although it may be desirable to impose dividend treatment where there is less than 80% control in a new corporation, the problem would seem to lie in the statutory definitions of reorganization, not in the concepts. The appropriate cure, if there is an ill, is to change the requirements for a reorganization.

The vague phrase, "may have the effect," renders the entire regulation meaningless and totally hides the thoughts of the draftsman. The reference to section 301 is equally perplexing because section 331(b) explicitly states that section 301 shall not apply to distributions in partial or complete liquidation.

The second regulation is almost as lacking in foundation as the first. It was issued under section 301, and provides:

A distribution to shareholders with respect to their stock is within the terms of section 301 although it takes place at the same time as another transaction if the distribution is in substance a separate transaction whether or not connected in a formal sense. This is most likely to occur in the case of a recapitalization, a reincorporation, or a merger of a corporation with a newly organized corporation having substantially no property.¹⁵²

This regulation appears to be inspired by the *Bazley* case.¹⁵³ However, Congress resolved the *Bazley* situation by section 356(d), and in

150. *Commissioner v. Berghash*, 361 F.2d 257 (2d Cir. 1966); *Joseph C. Gallagher*, 39 T.C. 144 (1962), *appeals dismissed*, Nos. 18844, 18845 (9th Cir., Sept. 23, 1963); *accord*, *Pridemark, Inc.*, 42 T.C. 510 (1964), *rev'd in part on other grounds*, 345 F.2d 35 (4th Cir. 1965). *But see Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967) (where the court first concluded that there was no liquidation and then, as an independent matter, found that there was a reorganization); *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965) (In dictum, the court said that if a corporation liquidates but the shareholders do not sever themselves from the business enterprise, there will be no complete liquidation. However, the court did not say whether this would necessitate finding a reorganization).

151. See cases cited notes 26, 27 & 28 *supra*.

152. Treas. Reg. § 1.301-1(1) (1955).

153. The only example given in the regulations is indistinguishable from *Bazley*.

so doing obviated the necessity for any regulation based upon *Bazley*. Moreover, the theory underlying the regulation is totally inconsistent with section 356(d). The statute considers the distribution to be part of the reorganization and then taxes it as a dividend. However, the regulation attempts to treat the distribution as separate from the reorganization. Finally, not only is the foundation of the regulation shaky, but, in addition some of its language is ambiguous. The phrase "in substance a separate transaction whether or not connected in a formal sense" is unexplained and the reference to "reincorporation" and "mergers" with new corporations is text without context.

Revenue Ruling 61-156,¹⁵⁴ in revoking Revenue Ruling 56-541,¹⁵⁵ represents a synthesis of all of the abovementioned weapons. The ruling has been severely criticized.¹⁵⁶ In the ruling, a corporation in liquidation sold all of its assets to a new corporation formed by the management of the old corporation for 45% of the stock, cash, and notes of the new corporation. Immediately thereafter, the new corporation sold 55% of its stock to the public and the old corporation liquidated. The ruling holds this to be a recapitalization ((E) reorganization) followed by a change in identity ((F) reorganization). The sale of stock to the public was:

disregarded as being a separate transaction, since even without it the dominant purpose — to withdraw corporate earnings while continuing the equity interest in substantial part in a business enterprise conducted in corporate form — was fully achieved. The issuance of stock to new investors was not needed to implement the dominant purpose and, therefore, the rest of the transaction was not fruitless without it and so dependent on it.¹⁵⁷

The primary authorities relied on in the ruling were sections 1.331-1(c) and 1.301-1(1) of the regulations, the legislative history referred to above, and *Bazley*. The retention of 45% of the stock was explained as a sufficient continuity of interest,¹⁵⁸ and neither section 368(a)(1)(D) nor *Southwest* was mentioned. The ruling is most

154. 1961-2 CUM. BULL. 62; See p. 507 *supra*. See generally Goldman, *Revised "Reincorporation Doctrine" Upsets Planners*; *Rev. Rul. 61-156 Analyzed*, 17 J. TAXATION 148 (1962).

155. 1956-2 CUM BULL. 189 (holding that when owners of 80% of the stock of the old corporation owned 45% of the stock of the new corporation, there was no reorganization and the distribution in liquidation was not subject to dividend treatment).

156. See Morrison, *The Line Between Liquidations and Reorganizations*, 41 TAXES 785, 792-99 (1963); Nicholson, *Recent Developments in the Reincorporation Area*, 19 TAX L. REV. 123, 133-39 (1964); Whitaker, *Liquidation and Reincorporation*, U. SO. CAL. 1966 TAX INST. 191, 206.

157. 1961-2 CUM. BULL. 62, 63.

158. The ruling cites *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) for support.

notable for its lack of authority. As such, it is, at best, a mere bootstrap ruling for a *Gallagher* type of situation.

Furthermore, Revenue Ruling 61-156 apparently ignores the fact that the sale of stock to the public did cause a substantial change in the economic position of the parties. By disregarding this step the ruling disregards the net effect of the entire transaction.¹⁵⁹ The transaction was not a sham, nor did it lack economic substance, and therefore, it should be taken into account notwithstanding the fact that it was motivated by the desire to minimize taxes.¹⁶⁰ Pursuant to the ruling there would be a tax on the boot under section 301. This would result in harsher tax treatment than if the old shareholders had held 80% of the stock of the new corporation so as to qualify the transaction as a (D) reorganization. Under section 301, the boot is taxed as a dividend in full, while under section 356, the boot from a (D) reorganization is taxed as a dividend only to the extent of the gain in the transaction. The ruling neither justifies nor recognizes this harsher result.

These criticisms of the ruling are equally applicable to the result that the "functionally unrelated" theory would produce in *Gallagher*. There seems to be little difference between segmenting a transaction by a "dominant purpose" or by a "functionally unrelated" theory.

B. The Judicial Technique

The problem of discerning what events are part of the reorganization is caused by three sections. Section 354(a)(1) provides that: "No gain or loss shall be recognized if stock or securities . . . are, *in pursuance of the plan of reorganization*, exchanged solely for stock or securities. . . ."¹⁶¹ Section 356 provides that if section 354 would apply but for the fact that there is also received other property, then gain will be recognized but only to the extent of the value of the other property. Although section 368 defines "reorganization," it does not define "in pursuance of the plan of reorganization." Just as the statute is unclear, so the courts have never clarified the constituent elements of "the reorganization."¹⁶² Three types of theories have developed, however.

159. See Nicholson, *supra* note 156, at 134-36.

160. United States v. Cumberland Pub. Serv. Co., 338 U.S. 451 (1950); Granite Trust Co. v. United States, 238 F.2d 670 (1st Cir. 1956); Commissioner v. Day & Zimmerman, Inc., 151 F.2d 517 (3d Cir. 1945). *But see* Woodworth v. Commissioner, 218 F.2d 719 (6th Cir. 1955) (court recognized validity of desire to minimize taxes but still held against taxpayer).

161. Emphasis added.

162. See generally Manning, "In Pursuance of the Plan of Reorganization": The Scope of the Reorganization Provision of the Internal Revenue Code, 72 HARV. L. REV. 881 (1959).

1. *Mutual Interdependence*. — The first is generally called the “mutual interdependence” test. The theory had its origin in an article by Randolph Paul,¹⁶³ but it is generally associated with the *American Bantam Car Co.*¹⁶⁴ case. This case involved a bankrupt corporation, American Austin Car Company, which was liquidated under the direction of the bankruptcy court in 1935. The assets were sold to three associates for \$5000 in cash and the assumption of liabilities of \$219,099.83. The associates then transferred the property to the newly formed American Bantam Car Company for stock. Because the corporation needed cash to commence operations, a contract was simultaneously entered into with underwriters who agreed to sell preferred stock and to be paid in common stock in addition to their underwriting discounts and commissions. Payments to the underwriters were contingent upon the sale of the preferred stock.

The litigation centered on a determination of the basis of the assets for purposes of depreciation. This determination turned on whether the incorporation was tax-free under section 112(b)(5) of the Revenue Act of 1936, which in turn depended on control as defined in section 112(h) of the same Act (which section is comparable to the current section 368(c)). By October of 1937, the associates no longer held 80% of the stock and the question was whether they had control “immediately after the exchange.” The taxpayer argued that all of the steps were part of one transaction, the end result of which was that the associates had no control. The court held that the transaction was complete upon transfer of the assets to the petitioner. The test was stated as: “Were the steps so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series?”¹⁶⁵ What does “fruitless” mean? The court answered the question by saying:

The understanding with the underwriters for disposing of the preferred stock, however important, was not a *sine qua non* in the general plan, without which no other step *would* have been taken. While the incorporation and exchange of assets would have been purposeless one without the other, yet both *would* have been carried out even though the contemplated method of marketing the preferred stock might fail.¹⁶⁶

The factors which motivated the court were that, before their transfer to the corporation, the associates were not contractually bound

163. R. PAUL, *Step Transactions*, in *SELECTED STUDIES IN FEDERAL TAXATION* 200 (2d Series 1938).

164. 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950).

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166. *Id.* at 406-07 (emphasis added).

to transfer stock to the underwriters, and that the underwriters had, at best, only contingent rights of ownership. The court was convinced that the associates would have created the new corporation regardless of the contract with the underwriters and that the associates intended to be in control of the corporation until the underwriters sold stock to the public. The test of the court was not "could" one step have been taken without the other, but rather, "would" one step be so taken. As such, the test is no more than a formula for seeking the subjective intent of the parties,¹⁶⁷ and the holding is a finding that the parties *would* have taken one step, regardless of the other.

Subsequent cases support this analysis.¹⁶⁸ Where the parties had *no intention* of retaining 80% control and at the date of transfer had already executed a "firm commitment" underwriting contract, the transfer and sale of stock were held to be mutually interdependent.¹⁶⁹ The manifest intent of the parties controls whether or not this theory will,¹⁷⁰ or will not,¹⁷¹ be invoked. But when the courts believe that the parties would take the first step regardless of the success of the second and when they were not bound to take the second when they took the first the steps will not be combined.¹⁷²

It has been suggested that since most of the "mutual interdependence" cases involve questions of "control immediately after" the transfer, the doctrine should be restricted to this issue.¹⁷³ This would give too great an emphasis to the doctrine. While it has been used loosely,¹⁷⁴ it is an aspect of the broader test of "intent." It is to be noted that the cases under the test have considered the intent of the parties not for determining whether they intended to do something to save taxes, but for determining the narrow issue of intent to control. Rather than being an independent test justifying the segmenting of

167. See Mintz & Plum, *Step Transactions in Corporate Reorganizations*, N.Y.U. 12TH INST. ON FED. TAX. 247, 285 (1954).

168. Compare *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1964); *Henning Corp.*, 19 CCH Tax Ct. Mem. 461 (1960); *Southwell Combing Co.*, 30 T.C. 487 (1958); and *First Seattle Dexter Horton Nat'l Bank*, 27 B.T.A. 1242 (1933), *aff'd*; 77 F.2d 45 (9th Cir. 1935); with *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955), *aff'g* 20 T.C. 636 (1953) and *Scientific Instrument Co.*, 17 T.C. 1253 (1952), *aff'd per curiam*, 202 F.2d 155 (6th Cir. 1953).

169. *Overland Corp.*, 42 T.C. 26 (1964); *accord, e.g.*, *Hazeltine Corp. v. Commissioner*, 89 F.2d 513, 518 (3d Cir. 1937); *Bassick v. Commissioner*, 85 F.2d 8, 10 (2d Cir.), *cert. denied*, 299 U.S. 592 (1936).

170. See *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415, 418 (8th Cir. 1955); *Avco Mfg. Corp.*, 25 T.C. 975 (1956); *Scientific Instrument Co.*, 17 T.C. 1253, 1257-58 (1952).

171. See *South Bay Corp. v. Commissioner*, 345 F.2d 698, 704-05 (2d Cir. 1965); *cf. Maine Steel, Inc. v. United States*, 174 F. Supp. 702 (D. Me. 1959).

172. See, e.g., *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955); *Scientific Instrument Co.*, 17 T.C. 1253 (1952).

173. Mintz & Plum, *supra* note 167, at 252-53, 285.

174. See, e.g., *Commissioner v. National Bellas Hess, Inc.*, 220 F.2d 415 (8th Cir. 1955); *Scientific Instrument Co.*, 17 T.C. 1253 (1952). See pp. 519-20 *supra*.

a transaction, the "mutually interdependent" test is merely another judicial phrase of art which is, or should be, used to describe, in shorthand, one method for determining what was actually intended by the parties to be included within the entire transaction. No case has been found in which the doctrine was invoked to justify segmenting the transaction¹⁷⁵ where: there was a contract to do a number of things, the parties intended to do all of them, the parties had no way of avoiding any steps after the first was taken, the parties would not have done one without the other, and the parties did all of the things.

2. *Step-Transactions*. — Cases professing to adopt the "step-transaction" approach do not afford any stronger authority for the Commissioner's theory of segmentation.¹⁷⁶ Unfortunately, the cases do not fall into distinguishable categories. Meaningless generalizations such as "form over substance," "tax effects depend on economic realities," and "mere shams will be disregarded" do not go far in embodying the Code with substantive meaning.

Nonetheless, certain patterns have been established. In *Liddon v. Commissioner*,¹⁷⁷ a husband and wife owned 80% of the stock of a Pontiac dealership. Davis, the general manager, owned the remaining 20%. In 1948, Davis wished to retire and on April 26, 1948, the shareholders voted to liquidate the corporation. On May 1, 1948, the new Liddon Pontiac Corporation was created and owned entirely by the Liddons. The old corporation sold its assets at book value to the new corporation. The new corporation also entered into a new franchise agreement with Pontiac, the old agreement having been previously cancelled. The Liddons received over \$150,000 from the old corporation and invested \$25,000 in the new corporation. Both the Tax

175. *But see* Rev. Rul. 61-156, 1961-2 CUM. BULL. 62, discussed at pp. 519-20 *supra*. In *American Bantam Car Co.*, 11 T.C. 397 (1948), *aff'd per curiam*, 177 F.2d 513 (3d Cir. 1949), *cert. denied*, 339 U.S. 920 (1950), there was a contract, but the rights under the contract were contingent. The court believed that the case differed from one where a contract establishes rights which are not dependent upon subsequent acts of the parties. *Compare* *Overland Corp.*, 42 T.C. 26 (1964). Regardless of the validity of the distinction, the inquiry for the court was whether the parties intended one element of the transaction to be absolutely linked to the accomplishment of the other.

176. Although Mintz & Plumb, *supra* note 167, at 285, agrees with the text, Manning, *supra* note 162, does not. According to Manning, "the fact that a reorganization is planned should not necessarily bring the entire transaction under the reorganization provisions. There is a difference between a plan which involves a reorganization and a plan of reorganization." *Id.* at 897. Manning suggests that an element must be "directly germane to the readjustment of a corporate business in modified forms." *Id.* at 910. "[T]he question is whether it furthers the readjustment. . . ." *Id.* at 898. Theoretically, the solution is appealing. Nonetheless, it is as meaningful to apply Manning's test in cases such as *Gallagher* as it is to use a "functionally unrelated" test. The suspicion remains that, at least for the *Gallagher* type of situation, the solution lies in a change in the Code.

Court and the Sixth Circuit rejected the Liddons' argument that because this was a liquidation, it could not be a reorganization. Rather they held that this was a reorganization and that the boot was taxable as a dividend. The Sixth Circuit found that the parties intended from the beginning to take each step and that all the steps were part of the "plan of reorganization." The flavor of the judicial attitude is apparent in the following passage:

Moreover, we are of the opinion that the Tax Court was correct in analyzing what was done in this case from the point of view of its overall net effect, rather than to permit one isolated transaction in a series to determine the tax consequences. The tax law, as has been often said, seeks generally to deal with substance rather than form, and particularly is this so in reorganization cases. "Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair. . . . Here they were no more than intermediate procedural devices utilized to enable the new corporation to acquire all the assets of the old one pursuant to a single reorganization plan." *Helvering v. Alabama Asphaltic Limestone Co.*, 1942, 315 U.S. 179, 184-185.

Steps are combined, or not combined, most frequently on the basis of what the parties intended to be in the "plan of reorganization."¹⁷⁹ Quite often the court will say that combining the steps in such a situation is the approach most consistent with congressional intent.¹⁸⁰ Again, as in *Liddon*, courts will often then claim to base the tax results on the "net effect" of the transactions.¹⁸¹

178. *Id.* at 309.

179. Compare *Moffatt v. Commissioner*, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); *South Bay Corp. v. Commissioner*, 345 F.2d 698 (2d Cir. 1965); *Pebble Springs Distilling Co. v. Commissioner*, 231 F.2d 288 (7th Cir.), *cert. denied*, 352 U.S. 836 (1956), *aff'g* 23 T.C. 196 (1954); *May Broadcasting Co. v. United States*, 200 F.2d 852 (8th Cir. 1953); *Barker v. United States*, 200 F.2d 223 (9th Cir. 1952); *Survaunt v. Commissioner*, 162 F.2d 753 (8th Cir. 1947); *Heller v. Commissioner*, 147 F.2d 376 (9th Cir.), *cert. denied*, 325 U.S. 868 (1945); *Love v. Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Hazeltime Corp. v. Commissioner*, 89 F.2d 513 (3d Cir. 1937); *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir.), *cert. denied*, 293 U.S. 611 (1934); *Estate of James F. Suter*, 29 T.C. 244 (1957) and *First Seattle Dexter Horton Nat'l Bank*, 27 B.T.A. 1242 (1933), *aff'd*, 77 F.2d 45 (9th Cir. 1935), *with* *United States v. Arcade Co.* 203 F.2d 230 (6th Cir.), *cert. denied*, 346 U.S. 828 (1953); *Benricksen v. Braicks*, 137 F.2d 632 (9th Cir. 1943); *Anheuser-Busch, Inc. v. Helvering*, 115 F.2d 662 (8th Cir. 1940), *cert. denied*, 314 U.S. 625 (1941), *aff'g* 40 B.T.A. 1100 (1939); *Sharp v. United States*, 263 F. Supp. 884 (S.D. Tex. 1966); *Charles R. Mathis, Jr.*, 19 T.C. 1123 (1953), and *Robert Campbell*, 15 T.C. 312 (1950).

180. See, e.g., *Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *George Whittel & Co.*, 34 B.T.A. 1070 (1936).

181. See, e.g., *Moffatt v. Commissioner*, 363 F.2d 262, 266 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); *James Armour, Inc.*, 43 T.C. 295 (1964); *David*

In all of these cases, the question involved a determination of which steps were in the "plan of reorganization." This, in turn, depended on a judicial interpretation of the subjective intent of the parties. The reason given for combining the steps was to prevent avoidance of tax by an artificial separation of those steps which the parties intended to be part of the entire plan. Granted, one can generalize and say that the courts held that the tax results were a function of the "net effect" intended by the parties. But this simplification ignores the fact that the "net effect" was nonetheless a "reorganization" within the statutory definitions and that no steps which the parties intended to be necessary parts of the transaction were separated from the plan of reorganization.¹⁸²

3. *The "Functionally Unrelated" Test.* — By way of contrast, the *Davant-Reef* approach ignores both the steps intended and the steps actually taken by the parties. It seeks to tax the motive of the parties, not their actions. The contrast between the approaches can be easily seen: the "mutually interdependent" and "step-transaction" theories combine or separate steps on the basis of what was done and then apply the Code to the final result actually achieved, while the "functionally unrelated" test segments a whole transaction and then recasts the form in order to tax a hypothetical step where the end form intended and achieved could not be so taxed under the present Code. In *Reef*, if the court merely looked at the position of the parties before and after the series of transactions, and if it held that the tax consequences would depend on this end result, regardless of the means used to reach it,¹⁸³ the court would probably not have held that there was an (F) reorganization due to the drastic shift in the proprietary interests. It was only by recasting the transaction into a redemption, an unrelated change of corporate shells, and a dividend, and then imposing tax consequences not on the basis of the end result but on the basis of what the tax consequences would be if these recast steps were the form that the parties chose, that the court was able to find an (F) reorganization. If a taxpayer cannot create forms in order to escape taxes,¹⁸⁴ there appears to be no reason why the Commissioner

182. *But cf.* *Bazley v. Commissioner*, 331 U.S. 737, 741-42 (1947); *Bard-Parker Co. v. Commissioner*, 218 F.2d 52, 55-56 (2d Cir. 1954), *cert. denied*, 349 U.S. 906 (1955); *Bedford v. Commissioner*, 150 F.2d 341, 343, (2d Cir. 1945) (where, however, the segmentation was based upon the intent of the parties).

183. "A given result at the end of a straight path is not made a different result because reached by following a devious path." *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

184. *See, e.g.*, *Gregory v. Helvering*, 293 U.S. 465 (1935); *Liddon v. Commissioner*, 230 F.2d 304 (6th Cir.), *cert. denied*, 352 U.S. 824 (1956); *Survaunt v. Commissioner*, 162 F.2d 753 (9th Cir. 1947).

can create forms in order to impose taxes. It is one thing to ignore a "meaningless" step, but it is quite another to tax a form that the Commissioner has substituted for what was actually done.

The other major fault in the "functionally unrelated" test is that it is inherently self-contradictory. In *Reef*, as in Revenue Ruling 61-156,¹⁸⁵ the Commissioner, in effect, argues that the steps must be combined and the transaction viewed as a whole in order to determine the net effect. Once this is done, the steps are then separated in order to find, or create, a step to which, in isolation, the Code can be applied. In *Gallagher* and in Revenue Ruling 61-156, the Commissioner articulated this as taxing the "dominant motive." This formula is no different, in substance, from the "functionally unrelated" formula. Similarly, section 1.331-1(c)¹⁸⁶ of the Regulations seeks to combine transactions in order to ignore a liquidation, while section 1.301-1(1)¹⁸⁷ seeks to segment. Revenue Ruling 61-156 invokes both. It is difficult to understand how a single step can be both part of a transaction and not part of it.¹⁸⁸

Thus, the "functionally unrelated" test not only lacks authority, but also lacks logic. To apply it to *Gallagher*, and to impose a (D) or (F) reorganization, requires one to view the transaction as a redemption of some shareholders, an independent transfer of the assets to a new corporation with a concomitant distribution of boot to the continuing shareholders, and an isolated sale of stock to new persons. Thus the end result is neither a (D) reorganization, because the 80% control requirement is not met, nor an (F), since there is a shift in proprietary interests. But, in order to tax the "dominant motive" of withdrawing earnings, the "functionally unrelated" step is created and taxed. The taxation of motives is not yet part of the Code. Moreover, given the length and complexity of the Internal Revenue Code, one would expect that if an end result were to have a certain tax effect, there would be authority in the Code for it. The use of the "functionally unrelated" concept is not a case of interpreting the statute to define what is part of a "plan," but is instead an attempt to change the statute so as to avoid the control requirements of section 368(a)(1)(D).

The thrust of the foregoing analysis suggests that the "functionally unrelated" concept has virtually no authority to support it and is inconsistent with the concepts heretofore used to determine which parts of a series of transactions are to be grouped together for tax

185. 1961-2 CUM. BULL. 62. See pp. 519-20 *supra*.

186. See p. 517 *supra*.

187. See p. 518 *supra*.

188. Whitaker, *Liquidation and Reincorporation*, U. SO. CAL. 1966 TAX INST.

purposes. The action of the Commissioner in this area is very different from his action in other situations where the literal language of the Code is not met.¹⁸⁹ The analysis of the Commissioner does not ignore a requirement where, in the final form, its effect has been realized; instead, it ignores a requirement where, in the end, the 80% control requirement of (D) has not been fulfilled. If a provision of section 368(a)(1)(D) is to be repealed, then Congress should do the repealing.

V. CONCLUSION

It is probably safe to assume that the taxpayers in *Gallagher* proceeded as they did in order to remove cash from the corporation at capital gains rates. If so, and if the 80% control test of (D) is a simple way to avoid dividend treatment, the solution would appear to lie in reducing the per cent of control needed under section 368(a)(1)(D), and not in either artificially segmenting transactions or in misusing section 368(a)(1)(F). The various legislative proposals directed at solving this problem have all adopted the former approach.¹⁹⁰ This tack would appear to be more sensible than the approach of the Commissioner because if *Davant-Reef* and Revenue Ruling 61-156¹⁹¹ are applied to *Gallagher* to tax the boot as a dividend, then section 368(a)(1)(D) will have been completely submerged in an unfounded concept of an (F) reorganization.

Both *Davant* and *Reef* held that there was a (D) reorganization. Therefore, the rejection of the "functionally unrelated" concept does not prevent the imposition of dividend treatment on the boot in those cases; rather, the rejection only precludes results for which the Code does not, at present, provide.

189. See p. 495 *supra*.

190. See, e.g., H.R. 4459, 86th Cong., 1st Sess. § 26 (1959); H.R. 8300, 83d Cong., 2d Sess. § 357 (1954). See also MacLean, *Problems of Reincorporation and Related Proposals of the Subchapter C Advisory Group*, 13 TAX L. REV. 407 (1958).

191. 1961-2 CUM. BULL. 62.