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Selected Tax Considerations in Bank Holding Company Formations: Charting a Course Through the Section 304/351 Labyrinth

BY STEWART E. CONNER* AND KEVIN J. HABLE**

INTRODUCTION

The proliferation of one-bank holding companies in recent years¹ has largely been the result of creative and resourceful tax planning. Of course, the one-bank holding company structure of bank stock ownership has numerous non-tax advantages.² These advantages include the numerous activities permitted bank holding companies and their non-bank subsidiaries,³ the geographic diversification permitted bank holding companies and especially their non-bank subsidiaries,⁴ the capital formation flexibility available,⁵ the less restrictive attitude of bank holding company regulators to

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¹ For the period from 1966 through 1976, 882 applications were filed with the Board of Governors of the Federal Reserve System seeking the approval of the formation of bank holding companies. For the period from 1977 through 1981, 2,367 such applications were filed. See Hakala & Austin, *Denials of BHC Formations and Acquisitions: Has There Been a Shift in Policy?*, 99 *BANKING L.J.* 947, 950 (1982).

² See generally Ford, *One-Bank Holding Companies for Community Banks*, 14 *TEX. TECH. L. REV.* 739, 743 (1983); Smith, *The Federal Income Tax Considerations Involved in Forming and Operating a Bank Holding Company*, 11 *MEM. ST. U.L. REV.* 453, 457 (1981).

³ See 12 U.S.C. § 1843. For example, a bank holding company may engage in activities that the Board of Governors of the Federal Reserve System has determined to be so closely related to banking or managing or controlling banks as to be a "proper incident thereto." 12 U.S.C. § 1843(c)(8) (1982); 12 C.F.R. 225.4 (1981) (Regulation Y). In addition, a bank holding company may own as much as 5% of the outstanding voting shares of any company, regardless of the business activities of that company. 12 U.S.C. § 1843(c)(7).

⁴ The Bank Holding Company Act of 1956, as amended, contains no restrictions limiting the geographic area in which a non-bank subsidiary of a bank holding company may operate. The Act does, however, preclude a bank holding company from acquiring a bank outside the state in which the operations of the holding company are principally conducted unless the acquisition is explicitly authorized by the statutes of the state in which the bank to be acquired is located. 12 U.S.C. § 1842(d) (1982) (the Douglas Amendment).

⁵ See Ford, *supra* note 2, at 747-51.

stock redemptions and similar capital adjustments,⁶ and the usual advantages incident to parent-subsidiary relationships.⁷ The great majority of one-bank holding companies, however, were created to take advantage of perceived favorable tax benefits.⁸ The tax advantages stem from the fact that, in the formation of most one-bank holding companies, the holding company assumes the indebtedness which the individual control shareholders had incurred in originally acquiring their bank stock.⁹ As this Article will discuss, the demise of fixed interest rate bank stock loans,¹⁰ the increase in regulatory scrutiny of correspondent bank relationships¹¹ and loans between a correspondent bank and the principals of its customer bank,¹² and the increased pressure on capital ratios¹³ have combined to make it difficult to acquire and maintain ownership of bank stock. The holding company's ability to file a consolidated federal income tax return with its subsidiaries is a benefit which helps to offset these difficulties.¹⁴ The non-tax advantages of a holding company organization certainly play a role in the move to such reorganizations, but the primary motivation appears to be the distinct tax advantages available.¹⁵

The flurry of bank acquisitions in recent years can rarely be explained by an analysis of the return on investment provided by the dividends paid by the banks acquired. More often than not the acquisition is more readily explained by the acknowledged intangible benefits derived from bank stock ownership as well as the

⁶ See, e.g., 12 C.F.R. § 225.6 (1981).

⁷ See text accompanying notes 50-54 *infra*.

⁸ See, e.g., Ford, *supra* note 2, at 739; Smith, *supra* note 2, at 453. See also Rutz, *The Tax Benefits of Forming One-Bank Holding Companies Under the Fed's New Guidelines*, 98 BANKING L.J. 24 (1981).

⁹ This Article does not deal with the myriad of tax issues involved in bank holding company transactions in which the acquisition debt of individual shareholders is not assumed by the holding company.

¹⁰ See notes 20-24 *infra* and accompanying text.

¹¹ See 12 U.S.C. § 1972(2) (1982).

¹² See notes 23-25 *infra* and accompanying text.

¹³ In addition to increased economic pressures, capital ratios are subject to strict regulatory scrutiny. See, e.g., BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM AND OFFICE OF THE COMPTROLLER OF THE CURRENCY, JOINT RELEASE REGARDING CAPITAL ADEQUACY (Dec. 17, 1981); DIVISION OF BANK SUPERVISION, FEDERAL DEPOSIT INSURANCE CORP., MANUAL OF EXAMINATION POLICIES, § G, at 2-4 (1982).

¹⁴ See notes 35-44 *infra* and accompanying text.

¹⁵ Smith, *supra* note 2, at 458.

possibility of substantial gain upon subsequent resale of the bank stock.¹⁶ In 1982 the average return on assets for all insured commercial banks in the United States was slightly in excess of 7/10 of 1%.¹⁷ Interestingly, banks with total assets of less than \$100 million earned an average return on assets slightly in excess of 1%.¹⁸ Insured commercial banks earned an average return on equity of 12.2%; banks with less than \$100 million in assets had an average return on equity of approximately 12.7%.¹⁹ In terms of dividend yield, these statistics indicate that an average dividend equal to 35% of net income would generate less than a 3% dividend yield on bank stock selling for 150% of its book value. Thus, unlike most other types of businesses, banks will rarely pay their own way in a leveraged transaction, absent the income tax benefits afforded by the holding company structure.

The question is often asked as to why it has taken so long for investors to realize this rather basic economic fact. If the holding company structure is truly the most beneficial way of maintaining bank stock ownership, why did it not become so widespread and popular until the early 1970's?²⁰

There are several answers to that question. First and foremost, until the 1970's, individuals acquiring control of a bank could usually secure a favorable fixed interest rate loan from the bank which would thereafter serve as the upstream correspondent for the bank to be acquired. Fixed rate loans were quite common for

¹⁶ One such benefit of bank ownership, often overlooked, is the equity building capability of a bank when compared to other types of businesses. In no small way, this can be attributed to the fact that the Internal Revenue Service has not attempted to impose the "accumulated earnings" penalty tax on banks. Normally, a substantial penalty is imposed on any unreasonable accumulation of earnings by a corporation beyond its reasonable business needs. See I.R.C. §§ 531-537 (1982). While this section could technically be applied to banks, the Service has not done so, presumably because of the nature of the banking business and the governmental policy of encouraging strong, well capitalized financial institutions.

¹⁷ 69 Fed. Res. Bull. 498 (1983) (statistics published by the Board of Governors of the Federal Reserve System).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ For the years 1966 through 1971 there were 147 applications filed with the Federal Reserve System for approval of bank holding company formations or acquisitions. For the years 1972 to 1976, applications totaled 735. See generally Hakala & Austin, *supra* note 1, at 950.

all types of loans, especially bank stock acquisition loans. It was also common knowledge that upstream correspondents would make loans on favorable terms so as to obtain the benefits of a lucrative correspondent bank relationship. This practice was brought to an end by a number of events. To begin with, fixed rate loans now appear to be anathema to most bankers because of the volatility of the interest rate markets caused by deregulation and the resulting stiff competition for core deposit dollars.²¹ In addition, Congress in 1978 enacted the Financial Institutions Regulatory and Interest Rate Control Act of 1978,²² which contains provisions subjecting loans between owners of banks and correspondent banks to increased regulatory scrutiny.²³ Among other things, the Act requires that loans to an affiliate of a bank by any correspondent of that bank be on terms no more favorable than terms extended to persons who are not affiliates of such banks.²⁴

Another reason for the delay in using the bank holding company structure was the fear of many tax practitioners that the dividends paid by the bank to the holding company could be considered personal holding company income²⁵ of the holding company and thereby assessed a penalty tax under section 541 of the Internal Revenue Code.²⁶ That problem was not resolved until 1971 when the Internal Revenue Service issued Revenue Ruling 71-531,²⁷ which indicated that such dividends are not to be considered in determining personal holding company income.²⁸

²¹ See Smith, *supra* note 2, at 458.

²² 12 U.S.C. § 1972.

²³ See *id.*

²⁴ See U.S.C. § 1972(1)(c).

²⁵ Under I.R.C. § 542 (1982), a corporation is a personal holding company if two conditions are met: first, if 60% of its adjusted gross income is personal holding company income under § 543; and, second, if at any time during the last half of the taxable year more than 50% in value of the corporation's outstanding stock is owned by no more than five individuals. Personal holding company income is defined by I.R.C. § 543, and includes, among other things, dividends, rents, mineral royalties, personal service contracts and income from trusts and estates.

²⁶ If a holding company were found to be a personal holding company, its income would not only be taxed at the usual corporate rates, but it also would be subject to a penalty tax on its undistributed personal holding company income at a rate of 50%. See I.R.C. § 541 (1982).

²⁷ Rev. Rul. 71-531, 1971-2 C.B. 242.

²⁸ *Id.*

The bank holding company structure was not used by investors in Kentucky until recent years because bank holding companies were not permitted until 1972, for all practical purposes. Prior to 1972, no "person"²⁹ could own more than one-half of the capital stock of a bank domiciled in Kentucky.³⁰ Thus, a bank holding company could have acquired only a minority interest in any Kentucky bank. Because of this, the holding company could not file a consolidated federal income tax return with the bank and therefore the major tax advantage offered by the holding company structure was not available.³¹ In 1972 the Kentucky statute was amended to permit one-bank holding companies, but prohibited such companies from acquiring any stock in any other bank.³²

I. THE TAX ADVANTAGES OF THE HOLDING COMPANY STRUCTURE

Basically, the tax advantages offered by the holding company structure center around the exception of the corporate holding company from the limitations on the deductibility of excess investment interest,³³ and the permissibility of filing a consolidated federal income tax return by the holding company and its 80% owned subsidiaries.³⁴

Individuals are subject to the excess investment interest limitations set out in section 163 of the Internal Revenue Code.³⁵ An individual making a substantial investment in bank stock on a leveraged basis must consider the fact that his or her interest deduc-

²⁹ KY. REV. STAT. § 287.030(3) (Bobbs-Merrill 1981) [hereinafter cited as KRS] defines a "person" as including "a natural person, partnership, corporation, association, business trust, voting trust, or similar organization."

³⁰ See *id.*

³¹ I.R.C. § 1501 allows consolidated returns to be filed for "an affiliated group of corporations." An affiliated group generally means a group of corporations connected by a common parent which owns at least 80% of the voting stock of the affiliates. I.R.C. § 1504 (1982). See generally I.R.C. §§ 1501-1505.

³² See KRS § 287.030(3). The Kentucky legislature recently passed House Bill No. 67, which allows a bank holding company to "acquire control of one (1) or more banks or bank holding companies." Thus, it will now be possible for bank holding companies to own more than one bank.

³³ See I.R.C. § 163(d)(1) (1982). See also text accompanying notes 43-44 *infra*.

³⁴ I.R.C. §§ 1501-1505.

³⁵ See I.R.C. § 163.

tion will be limited to an amount equal to his or her net investment income³⁶ plus \$10,000,³⁷ or plus \$25,000 if the debt giving rise to the interest deduction was incurred to acquire at least 50% of a corporation's stock.³⁸ The non-deductible portion of the interest paid each year is, of course, available in later years as an unlimited carryforward.³⁹ However, on a present value basis the carryforward is rarely a significant tax advantage.⁴⁰ Inasmuch as the section 163 limitations do not normally apply to corporations,⁴¹ a corporate shareholder of bank holding company stock is entitled to a current deduction for all interest paid each year on account of the acquisition indebtedness.⁴²

An individual is permitted to deduct the interest that he or she pays on indebtedness,⁴³ subject to the limitations regarding excess investment interest.⁴⁴ The source of funds for that payment is normally the dividends paid by the bank.⁴⁵ However, it is rare indeed that such dividends are sufficient to pay the entire interest bill. If one assumes that a well managed bank without particular portfolio problems will earn an average of 15% on its equity and if one further assumes that the normal dividend rate paid by the bank will not exceed 35-50% of its net earnings each year, it becomes apparent that an interest shortfall can be expected. An individual acquiring all of the issued and outstanding stock of a bank with an equity of \$1,000,000 would probably have to pay a premium in the area of 50% of total equity.⁴⁶ If that individual acquires 100%

³⁶ Net investment income is the excess of investment income over investment expenses. Investment income is derived from interest, dividends, rents and royalties while investment expenses include normal business expenses flowing from the investment. See I.R.C. § 163(d)(3).

³⁷ I.R.C. § 163(d)(1).

³⁸ I.R.C. § 163(d)(7).

³⁹ I.R.C. § 163(d)(2).

⁴⁰ For example, assuming that an appropriate discount rate is 11% per annum, the present value of the right to claim \$5,000 per year in interest deductions over a five year period (i.e., an aggregate of \$25,000 in deductions) would be worth only \$18,479.50.

⁴¹ Section 163 confines the limitation on excess investment interest to a "taxpayer other than a corporation." See I.R.C. § 163(d)(1).

⁴² See *id.*

⁴³ See I.R.C. § 163(a).

⁴⁴ See text accompanying notes 35-40 *supra*.

⁴⁵ See Smith, *supra* note 2, at 462.

⁴⁶ Such premiums are about average for closely held banks. See Meeker & Jay, *Price*

of the bank's stock for \$1,500,000 and finances 75% of the purchase price⁴⁷ at an interest rate floating with prime, the annual interest bill would, at the date of this writing, be approximately \$123,750.⁴⁸ If the bank continues its excellent earning record and returns 15% on its equity it will earn for the first year of new ownership \$150,000, and if prudently operated, will pay out not more than 50% of that amount in dividends, or \$75,000. Thus, the individual owning all of the stock of the bank would receive an annual dividend of \$75,000 with which to pay his or her annual interest statement of \$123,750. In addition, all of the interest may not be currently deductible depending upon the other investment income being earned by the individual involved.⁴⁹

On the other hand, a corporation which owns at least 80% of the voting power of all classes of stock of another corporation may elect to file a consolidated federal income tax return⁵⁰ which permits the members of the electing group to report their income and expenses as though they were a single entity.⁵¹ Therefore, the operating losses of one member of the group may be set off against the operating gains of a more profitable member of the group.⁵² In most one-bank holding company situations, the bank holding company, at least in its early years, has no source of income other than dividends from its bank subsidiary. If it files a consolidated federal income tax return with its bank subsidiaries, such distributions to it are not taxable income and therefore, the holding company will have no taxable income.⁵³ The holding company will,

Premiums for Controlling Shares of Closely Held Bank Stock, 53 JOURNAL OF BUSINESS 297 (1980).

⁴⁷ The Board of Governors of the Federal Reserve System imposes certain limitations on the ability of a holding company to leverage its acquisition of a bank. In the case of one-bank holding company formations involving banks with assets of less than \$150,000,000, a 300% debt to equity ratio is permitted if it can be shown that the ratio can be reduced to 30% within 12 years. See Federal Reserve Policy Statement, [1979-1980 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 98,218 (Mar. 28, 1980).

⁴⁸ At the date of this writing the prime rate quoted by major banks was 11% per annum. See 69 Fed. Res. Bull. A26 (1983).

⁴⁹ See text accompanying notes 35-40 *supra*.

⁵⁰ I.R.C. §§ 1501-1505. See Rutz, *supra* note 8, at 27.

⁵¹ I.R.C. §§ 1501-1505.

⁵² See *id.*; Treas. Reg. § 1.1502-11 (1980).

⁵³ Treas. Reg. § 1.1502-14 (1972). See also Rutz, *supra* note 8, at 27 n.13.

however, have substantial expense by virtue of the interest expense generated by the acquisition indebtedness assumed in the acquisition of the bank. That expense causes the holding company to generate a net operating loss. In the process of consolidation that loss is used to reduce the amount of bank subsidiary income which, but for that loss deduction, would be taxable to the bank. The tax savings is then normally passed up to the holding company as a "tax benefit payment."⁵⁴

The differences between individual and corporate ownership of bank stock are illustrated in the example set out in Table 1.

⁵⁴ Tax benefit payments represent payments from the bank to the holding company which are the result of the tax savings which the bank realized through the use of a consolidated return. See Rutz, *supra* note 8, at 33; Smith, *supra* note 2, at 463. Such payments are usually made pursuant to a consolidated tax return agreement between the bank and the bank holding company. Smith, *supra* note 2, at 463. This agreement typically provides that the bank will pay to the holding company an amount equal to the amount of tax it would have paid had it filed a separate tax return (the tax benefit). See *id.* The tax benefit is available for use by the holding company in paying its debt. See, e.g., Rutz, *supra* note 8, at 33. The use of such agreements in situations where there are minority shareholders in the bank is not free from doubt. Such minority shareholders may well argue that they should share in the benefit and receive a proportionate share of the payment. See F. O'NEAL, "SQUEEZE-OUTS" OF MINORITY SHAREHOLDERS § 3.18 (1975); Note, *Corporations—Affiliated Corporations—Agreement Allocating Overwhelming Share of Tax Savings from Consolidated Federal Income Tax Return to Parent Is Set Aside As Unfair—Case v. New York Cent. R.R.*, 77 HARV. L. REV. 1142 (1963-64); Note, *Corporate Fiduciary Doctrine in the Context of Parent-Subsidiary Relations*, 74 YALE L.J. 338 (1964). For a discussion of tax benefit payments in national banks, see Comptroller of the Currency Banking Circular 115 [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 97,580 (Aug. 30, 1978); Comptroller of the Currency Banking Circular 105, [1978-1979 Transfer Binder] FED. BANKING L. REP. (CCH) ¶ 97,458 (May 22, 1978).

TABLE 1

*Comparison of Cash Flow and Debt Repayment Schedules for Individuals and One-Bank Holding Companies**Assumptions*

The subject bank has assets of \$50,000,000 (50% of which are loans), equity capital of \$4,000,000 and a loan loss reserve of \$250,000. The bank earns 2% (prior to allowance for income tax) on its average assets each year and these assets grow at a compound growth rate of 10% per year. The bank pays a dividend each year equal to 40% of its net earnings. In the case of ownership by the one-bank holding company, the bank also pays to its shareholder a tax benefit payment equal to the product of the bank's marginal income tax rates times the interest expense the holding company incurs each year.

The purchase price for 100% of the stock of the bank is \$5,000,000 (125% of equity capital) and the acquisition loan is in the face amount of \$3,750,000 (75% of the purchase price). The loan bears interest at the rate of 11% per annum and is repayable over a period determined by applying excess cash flow to principal reduction.

It is assumed that the one-bank holding company's marginal income tax rate is 46% and that the bank's effective income tax rate is 30%.

	Year 1		Year 5		Year 8		Year 12	
	Individual	Holding Company	Individual	Holding Company	Individual	Holding Company	Individual	Holding Company
<i>Effect on Debt Repayment</i>								
Principal balance of loan at beginning of Year 1 and end of each other year (000s omitted)	\$3,750	\$3,750	\$4,127*	\$3,005	\$3,910*	\$1,917	\$2,535*	-0-
<i>Effect on Cash Available for Debt Repayment</i>								
Dividend of bank	294	294	430	430	573	573	839	839
Interest expense of shareholder "Tax benefit"	(413)	(413)	(452)	(357)	(444)	(259)	(334)	(8)
Payment	-0-	190	-0-	164	-0-	119	-0-	4
Cash available for (shortfall causing) payment of (increase in) principal	(119)*	71	(21)*	238	129	433	505	834
<i>Effect on Debt to Equity Ratio**</i>								
Ratio at end of year	250%	212%	120%	66%	66%	24%	22%	0%

* Because the amount of the dividends are insufficient to pay the interest on the loan in the first five years, it is assumed that the interest shortfall is rolled into the principal of the loan thus increasing the principal balance and resulting interest costs.

** As to both the holding company and the individual, this assumes an amortization of the premium paid for the bank stock (goodwill) over a 40-year period.

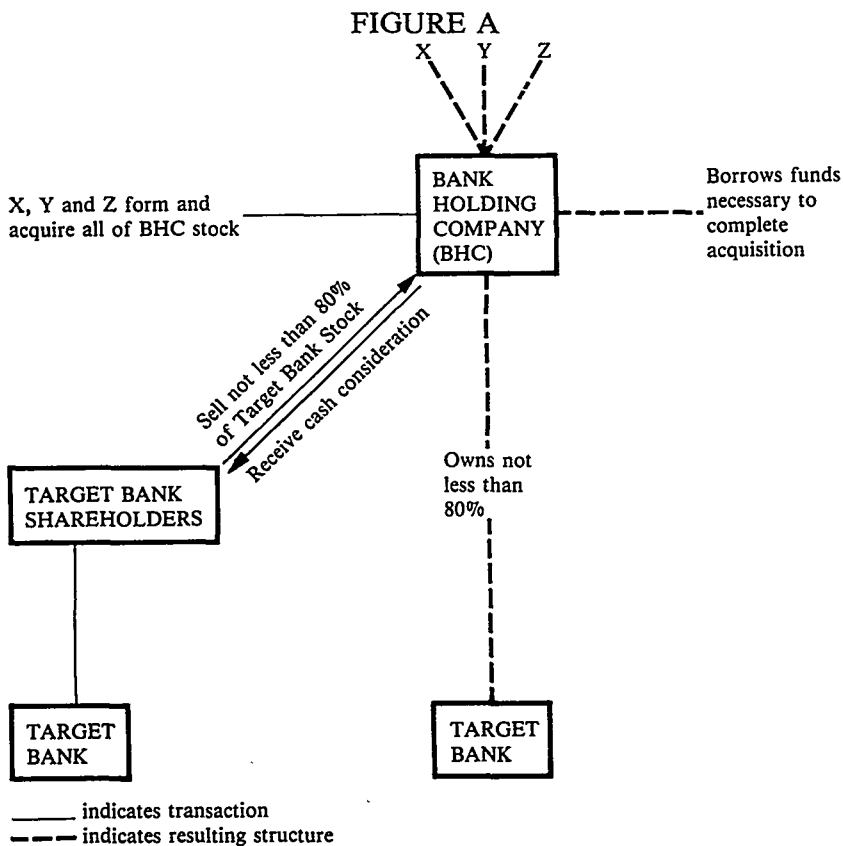
The example used in Table 1 demonstrates dramatically that the ability to retire the acquisition debt is greatly enhanced by the use of the holding company form of stock ownership. For the first five years the bank's dividends are not sufficient to pay even the interest on the acquisition debt, much less any payment on the principal. However, the availability of the "tax benefit" generated by the holding company structure not only covers the interest but also provides funds for substantial reductions in the principal of the loan. By the end of the twelfth year, the holding company has retired the entire debt while the individual owner has retired only \$1,215,000 in principal of the original debt and still owes \$2,535,000. Clearly, the tax savings offered by the holding company structure are substantial and, in most cases, are well worth the time and expense involved in the planning and implementation of the formation of the holding company.

II. METHODS OF ACQUISITION TO ACHIEVE THE DESIRED TAX RESULT

The easiest method of acquisition involves the formation of a new corporation by the purchasing individuals. The new corporation then contracts with the shareholders of the subject bank to acquire at least 80% of the voting power of all classes of the bank's stock,⁵⁵ obtains all required regulatory approvals, arranges for the necessary financing and thereafter closes the purchase transaction. Utilizing this method, the holding company owns at least 80% of the stock of the target bank and may thereafter elect to file a consolidated income tax return with the bank,⁵⁶ thus achieving results similar to those detailed in Table 1. This type of transaction, diagrammed in Figure A, would be treated for federal income tax purposes as a sale of stock by the bank shareholders to the holding company. This method of acquisition creates no serious tax problems, assuming it is properly structured.

⁵⁵ See I.R.C. §§ 351, 368(c) (1982).

⁵⁶ See I.R.C. §§ 1501, 1504.

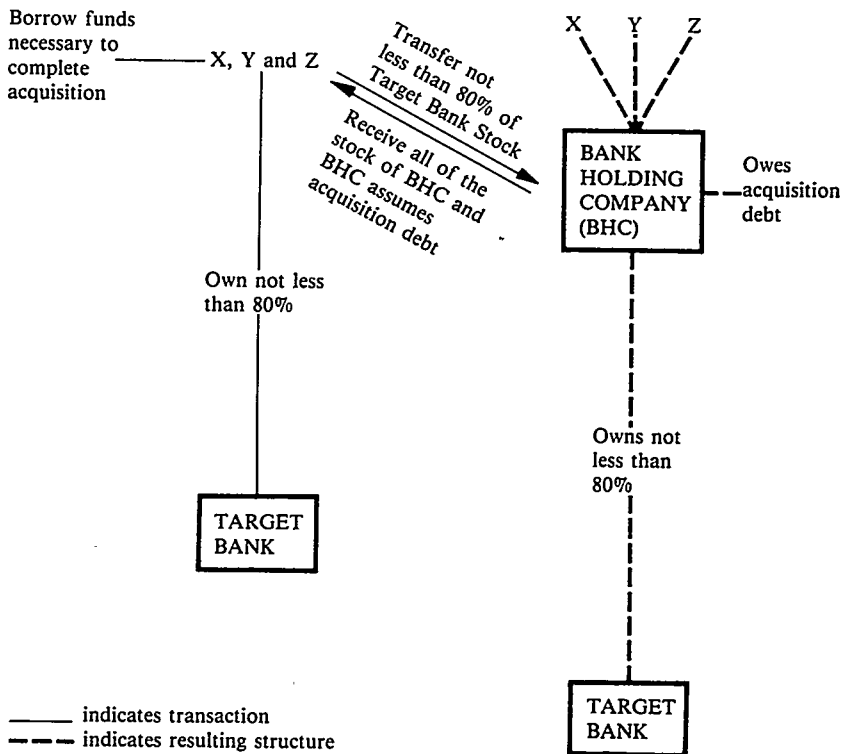


It is rare, however, that such transactions can be so structured. In most cases, one of two reasons prevents the use of such a simple, direct method. First, target shareholders are often not willing to wait the four to six month period necessary for the purchaser's new corporation to obtain the requisite regulatory approvals.⁵⁷ Most shareholders do not want to tie up their shares for that period of time, especially with no assurance that the requisite approvals will be forthcoming. Second, in many cases, the

⁵⁷ No company can acquire control of a bank without having first obtained the approval of the Board of Governors of the Federal Reserve System. See 12 U.S.C. § 1842. In the case of a one-bank holding company formation, the application process normally takes four to six months to complete.

individuals who wish to use the holding company structure already own the bank shares and have owned them for some time. Additionally, some individuals must purchase the shares in their individual capacities for timing reasons,⁵⁸ and then transfer the shares to the holding company in return for the holding company's stock and its assumption of the debt incurred by the individuals in making the acquisition. An example of this type of transaction is diagrammed in Figure B.

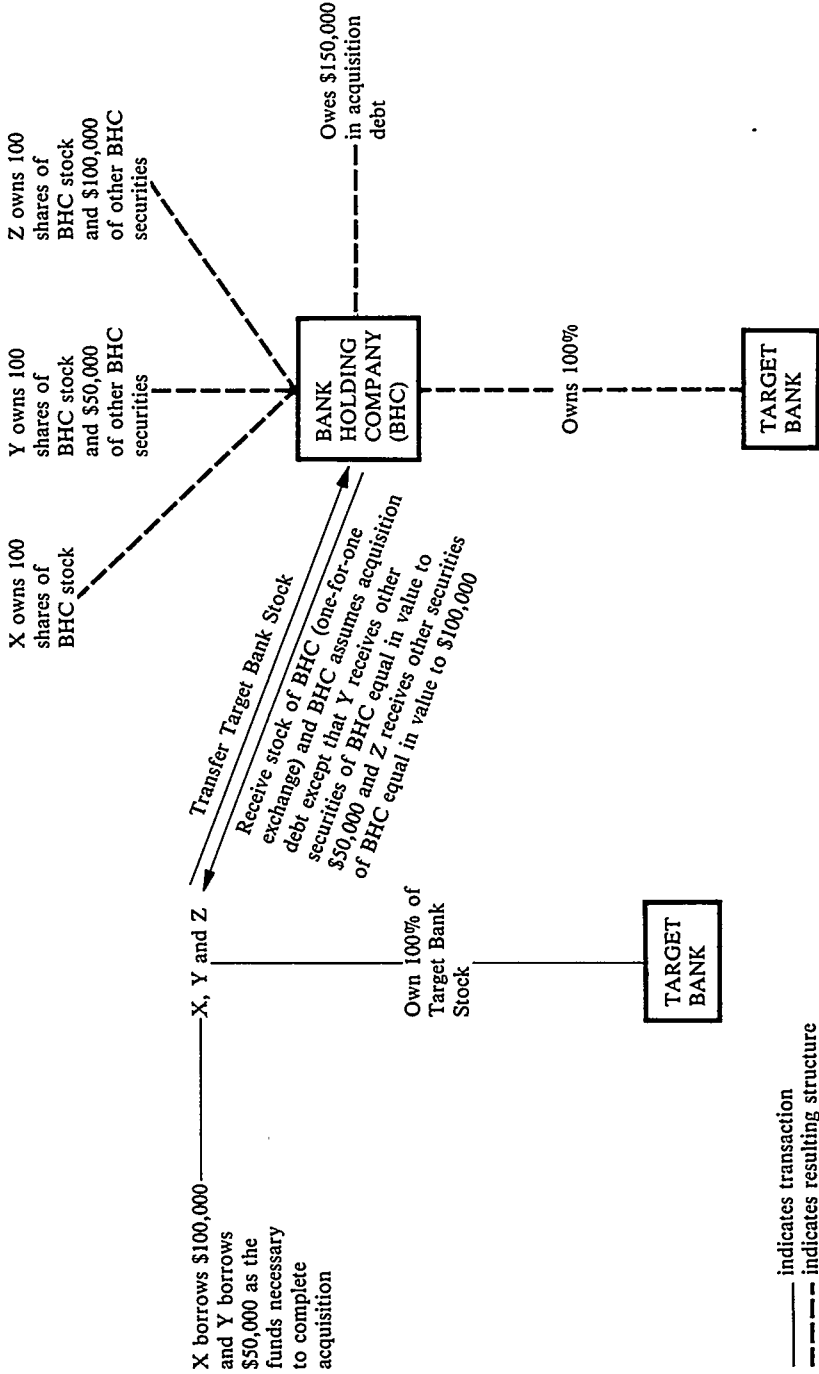
FIGURE B



⁵⁸ Even an acquisition of control by an individual is not free from delay by virtue of regulatory approvals. Such acquisitions are subject to the Change in Bank Control Act of 1978, 12 U.S.C. § 1817(j) (1982). Application is made to the primary bank regulator of the subject bank and the process usually takes no more than 60 days.

One variant of the foregoing methods should be discussed in light of its extensive use in bank holding company formations. This variant involves the use of debentures, preferred stock or other such securities of the holding company to equalize the consideration paid to the shareholders of the target bank participating in the formation transaction. If any of the shareholders participating in the formation transaction are not being relieved of any debt by the holding company then some additional consideration must be paid to them so as to equalize them with the shareholders who are having debt assumed. This is usually accomplished by issuing debentures, preferred stock or other securities of the holding company in an amount per share equal to the amount per share of debt being assumed. For example, assume that X, Y and Z each own 100 shares of the 300 issued and outstanding shares of stock of a bank and desire to place their stock in a bank holding company. Assume further that X incurred debt of \$100,000 in acquiring his 100 shares, Y incurred debt of \$50,000 in acquiring his 100 shares and Z incurred no debt in acquiring his 100 shares. It is obvious that if the three shareholders are to maintain equal equity positions in the holding company some additional consideration will have to be paid to Y and Z so as to equalize what they are receiving with the consideration X is receiving by virtue of the assumption of his debt by the holding company. Equally obvious is the fact that Z, who is having no debt assumed, should receive more of the additional consideration than Y, who is having some debt assumed, although less than the amount being assumed for the account of X. Since the highest amount of debt per share being assumed is \$1,000 ($\$100,000$ *divided by* 100 shares = \$1,000 per share), Z should receive \$100,000 of consideration in addition to the 100 shares of the holding company stock he will receive. This additional consideration could take the form of debentures or preferred stock in a face amount of \$100,000. In the case of Y, he is already receiving \$500 per share additional consideration by virtue of the holding company's assumption of his debt ($\$50,000$ *divided by* 100 shares = \$500 per share). Therefore he should receive debentures, preferred stock or other securities in the principal amount of \$50,000 ($\$1,000 - \$500 = \500×100 shares = \$50,000). The transaction diagrammed in Figure C illustrates this variation on the methods of acquisition.

FIGURE C



In all of these types of acquisitions, the tax result is more predictable now than it has been in the recent past because of the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).⁵⁹ However, the tax result is still not completely free from doubt. To comprehend fully the effect of TEFRA and the problems created by certain positions currently being taken by the Internal Revenue Service (IRS or Service), an understanding of the checkered history of the tax treatment of such transactions and the effect this history will have on current law is necessary.

III. THE HISTORY AND NATURE OF THE TAX PROBLEM

Individuals engaging in transactions similar to those diagrammed in Figures B and C obviously do not want to generate current taxable income while obtaining the future tax benefits offered by the consolidated tax return. In order to achieve these objectives, tax planners have often turned to the usually reliable tax free corporate organizational provisions of section 351 of the Internal Revenue Code.⁶⁰

Section 351(a) sets out the general rule that “[n]o gain or loss shall be recognized [by the transferors] if property is transferred to a corporation . . . solely in exchange for stock or securities in such corporation” and if the transferors of the property are in control (own 80% or more of each class of stock) of the transferee corporation immediately following the transfer.⁶¹ Section 351(b) provides that if any property or money (“boot”), other than stock and securities of the transferee corporation, is received by the transferors, the gain realized by the transferors in the transaction will be recognized to the extent of the amount of the “boot” received.⁶²

Based on the literal language of section 351(a), the transferors in the transactions diagrammed in Figures B and C should be entitled to section 351 treatment but would appear to have received “boot” inasmuch as they received something in addition to stock

⁵⁹ Pub. L. No. 97-248, 96 Stat. 324 (1982).

⁶⁰ See I.R.C. § 351. See generally B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 3.01-.21 (4th ed. 1979).

⁶¹ See I.R.C. § 351(a).

⁶² See I.R.C. § 351(b).

or securities from the transferee corporation, namely, relief of their liability on their acquisition indebtedness.⁶³ However, section 357(a) provides that if the transferee corporation in a section 351 exchange assumes a liability of a transferor, that assumption of liability will not constitute "boot" for purposes of section 351, so long as the principal purpose of the transaction was not to avoid federal income tax and the transaction was entered into for a bona fide business purpose.⁶⁴ In addition, section 357(c) provides that if the debt assumed exceeds the tax basis of the transferor in the property being transferred, such excess will be treated as gain to the transferor from the sale or exchange of the property transferred.⁶⁵ Assuming sections 351(a) and 357(a) control the transactions diagrammed in Figures B and C, the transferors could make the exchange on a tax deferred basis so that they would receive the holding company shares without incurring any current tax, but would be required to reduce their tax basis in the shares received by the amount of liabilities assumed.⁶⁶

Despite the fact that the language of section 351 seems to include the transactions diagrammed in Figures A, B and C, the Service has at times taken the position that section 304 of the Code applies to these types of transactions rather than section 351.⁶⁷ The

⁶³ If debentures are being issued in the transaction, they normally will not be classified as "boot" since § 351 permits the tax free receipt of not only stock but also "securities" of the transferee corporation. See I.R.C. § 351. If properly structured the debentures will constitute securities. See *id.* For a detailed discussion of the terms that debentures must have in order to be classified as securities, see B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 3.04.

⁶⁴ See I.R.C. § 357(a) (1982). Interestingly, the issues of tax avoidance motives or failure of a bona fide business purpose rarely arise in the bank holding company context. This is true undoubtedly because of the numerous perceived non-tax advantages of the holding company structure mentioned earlier in this Article. See notes 2-7 *supra* and accompanying text. It is questionable whether many, if any, of these alleged advantages have any effect on the decision to form a bank holding company. When the IRS was issuing rulings in this area in 1978 and 1979, it required, as a condition to the issuance of the ruling, a representation by the taxpayer that he or she did not intend for the holding company to assume the acquisition debt at the time it was originally incurred, and that the taxpayer was not engaging in the transaction merely to avoid the limitations on the deductibility of investment interest. See, e.g., IRS Private Letter Ruling 7830061. See also notes 115-16 *infra* and accompanying text.

⁶⁵ See I.R.C. § 357(c).

⁶⁶ See I.R.C. §§ 351(a), 357(a), 358(d) (1982).

⁶⁷ See text accompanying note 77 *infra*.

predecessor to the current section 304 was enacted in 1950⁶⁸ in an effort to prevent bailouts of earnings and profits. Bailouts could occur when one corporation sold its stock to another corporation under common control in order to avoid recognizing dividend income.⁶⁹ Section 304(a) provides that if one or more persons are in control⁷⁰ of two corporations and one of those corporations acquires stock in the other in return for property, the stock acquisition will be treated for tax purposes as a redemption of the stock of the corporation making the acquisition. If there is a redemption, then section 301, in conjunction with section 316, provides that a distribution of property by a corporation to its shareholders will be treated as a taxable dividend to the extent of the earnings and profits of the distributing corporation, unless the distribution satisfies the requirements of section 302(b).⁷¹

The argument as to which of these two Code sections controls such transactions has raged for years, with the IRS constantly changing its position and always for a different reason. In the 1960's and early 1970's the Service regularly issued private letter rulings indicating that such transactions were controlled by section 351 and thus could be effected on a tax deferred basis.⁷² Over the next several years the Service vacillated between applying section 304 and section 351 and in 1976 simply suspended giving advance rulings.⁷³

The courts did not lend any stabilizing influence to this confusing and complex issue. The only case dealing with the precise issue of the application of section 304 as opposed to section 351 is *Commissioner v. Stickney*.⁷⁴ In that case, the Sixth Circuit Court

⁶⁸ See B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 9.30.

⁶⁹ *Id.*

⁷⁰ For purposes of § 304, 50% stock ownership in terms of value or votes constitutes "control." In determining control under § 304, the constructive ownership rules of § 318 are generally applicable. See I.R.C. § 304(c).

⁷¹ I.R.C. §§ 301, 316 (1982). See also *Maier v. Commissioner*, 469 F.2d 225 (8th Cir. 1972) (standing for the proposition that the assumption of a liability is "property" for the purposes of §§ 304 and 317 of the Code), *rev'g* 55 T.C. 441 (1970).

⁷² Remarks of James E. Haugh, 1982 Kentucky Institute on Federal Taxation, Louisville, Kentucky (Dec. 3, 1982).

⁷³ *Id.*

⁷⁴ 399 F.2d 828 (6th Cir. 1968), *aff'g sub nom.* *Haserot v. Commissioner*, 46 T.C. 864 (1966). *Haserot* was first decided by the Tax Court in 1964. See *Haserot v. Commissioner*, 41 T.C. 562 (1964), *remanded*, 355 F.2d 200 (6th Cir. 1965).

of Appeals ruled that since section 304 necessarily must be read in connection with sections 301 and 302,⁷⁵ and since each of those sections begins with the phrase "[e]xcept as otherwise provided in this chapter," then section 351, which contains no such language, must necessarily control transactions falling literally within its statutory language.⁷⁶ The Service rejected the reasoning of the court of appeals and announced in Revenue Ruling 73-2 that it would not follow the decision in *Commissioner v. Stickney* for purposes of issuing advance letter rulings to taxpayers.⁷⁷ The Service's position in that Ruling has been the subject of extensive discussion over the last several years.⁷⁸

Some years later in *Rose Ann Coates Trust v. Commissioner*,⁷⁹ the Ninth Circuit Court of Appeals had an opportunity to consider the overlap issue in a somewhat different context. The lower court finessed the overlap question by concluding that the notes received by the taxpayers were not "securities" under section 351.⁸⁰ Under this reasoning, section 351 literally did not apply to the transactions.⁸¹ The court of appeals, however, decided to address the issue and held that the provisions of section 351 are overridden by the provisions of section 304 in such situations.⁸²

Faced with this split in the authorities and the continuing vacillation of the IRS, tax planners used a variety of methods to

⁷⁵ 399 F.2d at 834-35 (quoting *Haserot v. Commissioner*, 41 T.C. at 570).

⁷⁶ 399 F.2d at 834-35.

⁷⁷ See Rev. Rul. 73-2, 1973-1 C.B. 171. In 1978, the IRS reaffirmed Revenue Ruling 73-2 with regard to the 304/351 overlap. In Revenue Ruling 78-422, 1978-2 C.B. 129, an individual who owned all of the stock of the acquiring corporation (Y) purchased all the stock of the target corporation (X) with borrowed funds. Subsequently, the individual transferred his stock in Y corporation to X, in return for the assumption by X corporation of the indebtedness incurred by the shareholder in purchasing the stock of X. The Service ruled that § 351(a) applied to the individual's receipt of stock in X corporation, but that § 304(a), and not § 357(a), applied to the assumption of indebtedness by X corporation. Thus, the assumption of indebtedness was treated as a distribution of property under § 301.

⁷⁸ See, e.g., Beller, *The 351/304 Overlap: Some New Twists to an Old Problem*, 40 N.Y.U. INST. ON FED. TAX'N ch. 45 (1982).

⁷⁹ 55 T.C. 501 (1970), *aff'd*, 480 F.2d 468 (9th Cir.), *cert. denied*, 414 U.S. 1045 (1973).

⁸⁰ *Id.* at 512.

⁸¹ *Id.*

⁸² See 480 F.2d at 472 (citing *Haserot v. Commissioner*, 46 T.C. at 872-78 (Tannenwald, J., writing separately)).

avoid or minimize the effects of the possible application of section 304. If section 304 were found to be applicable to the transactions diagrammed in Figures B and C, then they would be viewed as mythical redemptions of the holding company's stock in amounts equal to the loans being assumed by the holding company.⁸³ Because these transactions would not satisfy the requirements of section 302(b),⁸⁴ the deemed redemptions would be characterized as section 301 distributions from the holding company to the shareholders whose debts are assumed in amounts equal to the deemed redemption price. Although section 304(b) provides that the distribution will be deemed to constitute a dividend only to the extent of the earnings and profits of the holding company, the Service made it clear that it could argue that the earnings and profits of the bank should be used to determine the amount of the dividend.⁸⁵ In an effort to avoid this issue, tax planners suggested to their clients that the new holding company file a separate tax return for its first tax year to ensure that the holding company would have no earnings and profits. Without any earnings and profits, no dividend would be possible.⁸⁶ While this method made any first year losses of the holding company unavailable for use

⁸³ I.R.C. § 304(a)(1).

⁸⁴ Section 302(b) of the Code provides that a redemption will be treated as a purchase of the stock and not as a dividend if the redemption can meet any one of four tests: (1) the redemption is not essentially equivalent to a dividend; (2) the redemption is substantially disproportionate with respect to the redeemed shareholder; (3) the redemption completely terminates the shareholder's interest in the corporation; (4) the redemption of a non-corporate shareholder is made in partial liquidation of the distributing corporation. I.R.C. § 302(a)-(b).

⁸⁵ See Rev. Rul. 80-239, 1980-2 C.B. 103. See also text accompanying notes 88-104 *infra*.

⁸⁶ *But see* *Maier v. Commissioner*, 469 F.2d at 225. In *Maier*, a shareholder transferred stock of a corporation controlled by him to another corporation also controlled by him in exchange for the assumption of the indebtedness incurred by the shareholder to acquire the stock. However, the shareholder remained secondarily liable for the payment of the indebtedness after the assumption by the transferee corporation. The court held that the shareholder did not receive a distribution of property at the time the indebtedness was assumed by the transferee corporation, but instead was deemed to have received a dividend distribution each time the transferee corporation made an installment payment on the indebtedness and reduced the shareholder's secondary liability. Therefore each distribution was deemed to be a dividend to the extent of the transferee corporation's earnings and profits at the time each reduction in the shareholder's secondary liability occurred. *Id.* at 225-28.

against the bank's income, it provided substantial protection against Service attack.

Careful tax planners also advised their clients not to issue any stock in the new holding company until the exchange transaction was ready to be implemented. In this way, the taxpayer could maintain that section 304 literally did not apply to the transaction since the two corporations were not under common control *before* the transfer of stock between those corporations.⁸⁷ Because the new holding company had not yet issued any stock, it could be argued that no one was in "control" of the holding company for the purposes of section 304. The requisite control would be extant only after the actual transfer of bank stock to the holding company.

In September, 1980 the Service issued two revenue rulings which acted as warning shots across the bow of careful tax planning. In Revenue Ruling 80-239⁸⁸ an individual who owned all of the stock of a manufacturing corporation formed a holding company, and caused that holding company to borrow funds from a third party lender. Thereafter he transferred his stock in the manufacturing corporation to the holding company in exchange for stock of the holding company and the proceeds of the loan. The loan was subsequently repaid by the holding company with funds received from the manufacturing corporation. The Service ruled that section 351 was applicable to the transfer of the manufacturing corporation's stock to the holding company in exchange for the shares of the holding company.⁸⁹ However, the ruling also indicates that the individual received a dividend from the manufacturing corporation in the amount of the loan proceeds which passed from the holding company to the individual in the exchange. The Service decided that section 351 did not govern the distribution of the loan's proceeds because the substance of that transaction was a distribution of cash to the individual by the manufacturing corporation and the holding company was merely a conduit through which the distribution to the individual was passed.⁹⁰

In Revenue Ruling 80-240,⁹¹ the taxpayer was an individual who

⁸⁷ See I.R.C. § 304. See also Treas. Reg. § 1.304-2(a) (1968).

⁸⁸ Rev. Rul. 80-239, 1980-2 C.B. 103.

⁸⁹ See *id.*

⁹⁰ See *id.*

⁹¹ Rev. Rul. 80-240, 1980-2 C.B. 116.

was seeking to acquire control of a bank by purchasing 10% of the bank's stock with personal funds and borrowing funds from an unrelated third party lender to purchase the remaining 90% of the bank's stock. Immediately after acquiring the bank's stock the individual formed a holding company and promptly transferred the newly acquired bank stock to the holding company in exchange for all of the holding company's stock and the holding company's assumption of the debt related to the acquisition of the bank's shares. The Service ruled that section 351 applied to the transfer of the bank's stock to the holding company, and that neither section 357 nor section 304 was applicable to the transfer because there had been no assumption of liability by the holding company.⁹² Instead, the Service characterized the transfer as having been made by an intermediary agent acting on behalf of the holding company and concluded that the assumption of the liability should therefore be disregarded.⁹³ In substance, the Service took the position that the transaction should simply be viewed as a transfer of the individual's bank stock (10% of the issued and outstanding stock) in exchange for 100% of the holding company's stock.

At the same time, the Service issued Revenue Procedure 80-34,⁹⁴ which was an amplification of Revenue Procedure 80-22.⁹⁵ These Revenue Procedures provide a list of certain areas in which the Service will not ordinarily issue advance rulings. Revenue Procedure 80-34 added to that list any transactions similar to that described in Revenue Ruling 80-240 unless the taxpayer could satisfy the IRS that the liability was incurred by the taxpayer as a mere intermediary agent for the newly created corporate transferee. In order to satisfy this requirement, the taxpayer was required to submit to the Service documented evidence, composed at the time the liability was incurred, indicating that the unrelated lender had agreed to release the taxpayer from any and all obligation on the liability.⁹⁶ In addition, the taxpayer was required to show or represent to the Service that the transfer and assumption

⁹² *See id.*

⁹³ *See id.*

⁹⁴ Rev. Proc. 80-34, 1980-2 C.B. 768.

⁹⁵ *See* Rev. Proc. 80-22, 1980-1 C.B. 654.

⁹⁶ Rev. Proc. 80-34, 1980-2 C.B. 768.

of the debt actually occurred within twelve months of the date the debt was incurred.⁹⁷

Both of the above Revenue Rulings, as well as the Revenue Procedures, were viewed cautiously by tax practitioners. It was clear that the Service was not giving up in its insistence that section 357 did not apply to the assumption of these types of liabilities. Rather than facing the overlap issue, the Service had opted for the vague and uncertain standard of agency, a concept wholly dependent on facts and circumstances. Although a few transactions could qualify for section 351 treatment under the narrow fact situations contemplated by Revenue Procedure 80-34, tax planners were unable to rely upon any definitive authority to resolve the 304/351 overlap question.

It took the Service less than three months to complete its attack on these types of transactions. In December of 1980, it became public knowledge that the IRS was considering the issuance of a revenue ruling which would have created absolute havoc in banking circles.⁹⁸ The proposed ruling considered a situation where individuals who had borrowed money in order to acquire shares of bank stock transferred all of their shares of bank stock to a newly formed holding company in exchange for holding company stock and the assumption of their acquisition indebtedness. Subsequent to the exchange, the bank loan was repaid by the holding company with funds received from the bank.⁹⁹ The bank shareholders who had incurred no debt in connection with their acquisition of their bank shares received additional non-voting stock in an amount sufficient to equalize the consideration received by each shareholder.¹⁰⁰

The proposed ruling concluded that the shareholder whose debt was being assumed received a dividend as a result of the transaction.¹⁰¹ The amount of the dividend was to be measured by the earnings and profits of the bank. The proposed ruling held that

⁹⁷ *Id.* Rev. Proc. 80-22 as amplified by Rev. Proc. 80-34, was superseded by Rev. Proc. 81-10, 1981-1 C.B. 647, which in turn was superseded by Rev. Proc. 82-22, 1982-1 C.B. 469, which in turn was finally superseded by Rev. Proc. 83-22, 1983-13 I.R.B. 74.

⁹⁸ See Battey, *Peat, Marwick Advises IRS To Let Stand Tax Break For 1-Bank Holding Companies*, AM. BANKER, Dec. 4, 1980, at 2.

⁹⁹ *Id.*

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

a distribution by a bank cannot be transformed for tax purposes into a distribution by a holding company by using the latter as a conduit through which to pass the assumption of acquisition indebtedness. Consequently, the majority shareholders would be treated as receiving a dividend equal to the cash equivalent of the amount of liabilities assumed.¹⁰² With this ruling, the Service would have finalized its position that, other than with respect to the actual stock exchange, neither section 351 nor section 304 applied to these types of transactions. When word of the proposed ruling became public, the reaction of bankers and their counsel was predictable, swift and vociferous. The American Bankers Association, together with the accounting firm of Peat, Marwick, Mitchell & Co., attacked the proposed ruling as being contrary to law and the previous positions taken by the Service.¹⁰³ In the face of this intense pressure, the Service agreed to withdraw the proposed ruling.¹⁰⁴

The years 1981 and 1982 were difficult for tax practitioners who were planning these types of transactions. The lack of definitive authority and the overt antagonism shown by the Service created great uncertainty in the entire area. This resulted in renewed discussion concerning the legislative proposal previously made by the American Bar Association Section of Taxation.

IV. THE ABA PROPOSAL

In 1979 the American Bar Association adopted a Recommendation of the ABA Section of Taxation (Recommendation) which would have resolved the 304/351 overlap problem.¹⁰⁵ The Recommendation proposed that section 304 and section 351 "be amended to provide that upon a transfer described in both sections 351 and 304 . . . the receipt of property other than stock of the transferee

¹⁰² See Letter from Gilbert D. Bloom (Peat, Marwick, Mitchell & Co.) to Treasury Tax Legislative Counsel John M. Samuels (Nov. 26, 1980), reprinted at 169 CONG. REC. S15467 (daily ed. Dec. 3, 1980).

¹⁰³ See Battey, *supra* note 98, at 2.

¹⁰⁴ Beller, *The 351/304 Overlap: Some New Twists to an Old Problem*, 40 N.Y.U. INST. ON FED. TAX'N § 45.05[2], at 45-29.

¹⁰⁵ See ABA Tax Section Recommendation No. 1979-3, reprinted in 32 TAX LAWYER at 1446-52 (1978-79) [hereinafter cited as Recommendation].

corporation and the assumption of certain liabilities shall be governed by section 304."¹⁰⁶

Under the Recommendation, the receipt of stock of the transferee corporation in a 304/351 transaction would be governed by the nonrecognition rules of section 351.¹⁰⁷ Section 304 would be applicable, however, to the receipt of money or debt securities of the transferee corporation.¹⁰⁸ In addition, under the Recommendation, section 304 would apply to the assumption of indebtedness by the transferee corporation, but only if the assumption lacked a bona fide business purpose or had as its principal purpose the avoidance of federal income tax.¹⁰⁹ Section 304 would also apply, under the amendments proposed by the Recommendation, to the excess of liabilities assumed over the basis of the stock transferred.¹¹⁰

The rationale of the Recommendation was identical to the reasoning of the Service in Revenue Ruling 73-2,¹¹¹ in which the Service announced that it would not acquiesce in the *Stickney/Haserot* holding.¹¹² The ABA Section of Taxation agreed with the Service that, if section 351 were to override section 304 in a 304/351 transaction, taxpayers owning more than 50% but less than 80% of the stock of the transferee corporation would be subjected to the likelihood of dividend treatment under section 304, while taxpayers owning at least 80% of the transferee corporation would be able to achieve the generally favorable tax results of section 351.¹¹³ The Recommendation concluded that the effect of such a section 351 override "would be to 'subject the person with a lesser interest and, therefore, a lesser ability to control the policies of the

¹⁰⁶ *Id.* at 1446.

¹⁰⁷ *Id.* at 1448-49.

¹⁰⁸ *Id.* at 1449.

¹⁰⁹ *Id.*

¹¹⁰ *Id.* Otherwise, the amount by which the assumption of liabilities exceeded the basis of the stock transferred would be governed by § 357(c) and "considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset, as the case may be." See I.R.C. § 357(c)(1).

¹¹¹ See note 77 and accompanying text *supra*.

¹¹² See *id.* For a discussion of the *Stickney/Haserot* decision see text accompanying notes 74-78 *supra*.

¹¹³ Recommendation, *supra* note 105, at 1448. See also Rev. Rul. 73-2, 1973-1 C.B. at 172.

corporation, to the more stringent requirements of Section 304'—clearly an illogical result."¹¹⁴

Under the Recommendation, section 304 would apply to the receipt of debt securities of the transferee corporation.¹¹⁵ The ABA Section of Taxation believed that the transfer of such securities to a transferor shareholder created the potential for a bailout.¹¹⁶ If section 351 alone governed the transaction, the receipt of the debt securities would not trigger gain recognition. The later redemption of those securities would result in capital gain treatment to the holder of those securities.¹¹⁷ The stock of the transferee corporation held by the shareholder could subsequently be transferred to another transferee corporation in exchange for stock and securities of the second transferee corporation in an exchange which would not generate gain recognition under section 351.¹¹⁸ The securities of that second transferee corporation could later be redeemed, producing gain taxable at capital gains rates.¹¹⁹ Thus, the transferor shareholder could, if the receipt of securities were governed by section 351, continually withdraw money from controlled corporations at the capital gains rate without a corresponding substantial reduction in ownership of that corporation. In fact, such withdrawals would be in the nature of a dividend and properly taxable at the higher ordinary income rates.¹²⁰ In addition, the securities received by the transferor shareholder could be immediately marketable, which could create a bailout potential similar to that which prompted the enactment of section 306.

The Recommendation was an attempt to provide certainty to this area of the law, but it failed to provide a completely satisfactory solution to the 304/351 problem, particularly as that problem

¹¹⁴ Recommendation, *supra* note 105, at 1448 (quoting Rev. Rul. 73-2, 1973-1 C.B. at 172).

¹¹⁵ *Id.* at 1449.

¹¹⁶ *Id.* ("The transfer by a controlled corporation of a related controlled corporation's stock presents clear bailout possibilities, because the corporation can later repay the securities without triggering dividend consequences to the holder.")

¹¹⁷ This occurs when the redemption is made in such a manner as to qualify as an exchange under I.R.C. § 302(b). See, e.g., B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 9.20.

¹¹⁸ See Recommendation, *supra* note 105, at 1449.

¹¹⁹ See I.R.C. §§ 302(b), 1232.

¹²⁰ *But see* United States v. Davis, 397 U.S. 301 (1970) (similar transaction found to be the equivalent of a dividend). For a discussion of *Davis* see text accompanying notes 140-47 *infra*.

related to the formation of bank holding companies. First, the Recommendation did not deal with section 304(b)(2)(A). This section provides that the determination of whether receiving property of the transferee corporation in return for stock of another controlled corporation constitutes a dividend under section 302(b) is to be made solely by reference to the earnings and profits of the transferee corporation.¹²¹ A newly formed holding company will not have accumulated earnings and profits at the time property is distributed to shareholders who exchanged their bank shares for holding company stock and other property.¹²² Thus, under a literal reading of section 304, the receipt of property in such a holding company formation will not result in dividend income for the transferring bank shareholder.¹²³ Second, the Recommendation did not recognize the customary method of acquiring banks described in Figure C above. The assumption of the indebtedness in a Figure C transaction would have been excluded from the coverage of section 304 under the Recommendation.¹²⁴ However, the receipt of debt securities by minority shareholders would result in gain recognition for such shareholders under section 304(a).¹²⁵

V. THE TREATMENT OF THE 304/351 PROBLEM IN TEFRA

In August 1982, Congress enacted the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),¹²⁶ which made several

¹²¹ See I.R.C. § 304(b)(2)(A) ("In the case of any acquisition of stock [by a related corporation] the determination of the amount which is a dividend shall be made solely by reference to earnings and profits of the acquiring corporation.").

¹²² See text accompanying note 86 *supra* for a discussion of one method of treating the earnings and profits of a newly formed holding company.

¹²³ See I.R.C. § 304(b)(2)(A). Since the holding company is the acquiring corporation and has no earnings and profits when the transaction occurs it follows that no dividend would result. See also B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 9.33 (4th ed. Supp. 1983).

¹²⁴ See Recommendation, *supra* note 105, at 1449 (with respect to liabilities assumed by the transferee corporation, any such liabilities which are described in § 357(a) would not be subject to tax under § 351).

¹²⁵ See I.R.C. § 304(a). See also Recommendation, *supra* note 105, at 1448-49 ("Under the Recommendation, to the extent that stock of the transferee corporation is received, and the exchange otherwise qualifies under section 351, the normal nonrecognition rules of section 351 would apply. Section 304 would apply, however, to the extent that cash or debt securities of the transferee are received.").

¹²⁶ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 325 (codified in scattered sections of 26 U.S.C.) [hereinafter cited as TEFRA].

substantial changes to the corporate and shareholder income tax provisions of the Code. Among those changes were amendments to section 304, which were similar to those proposed by the ABA Section of Taxation to provide a solution to the 304/351 overlap problem.¹²⁷ In TEFRA, Congress recognized the unique nature of bank acquisitions and provided special tax treatment for the receipt of bank holding company securities in narrowly defined circumstances where section 304 would otherwise apply.¹²⁸ Nevertheless, Congress, although providing much needed certainty in the 304/351 area, created additional ambiguities by imprecise drafting of the 304/351 TEFRA provisions.

By adopting the amendments to section 304 contained in section 226 of TEFRA, Congress dealt directly with the 304/351 overlap. New section 304(b)(3)(A) makes clear that, if section 304 and section 351 could both arguably apply to a transaction, then section 304(a), and not sections 351 and 357, will apply to any distribution of property made in connection with that transaction.¹²⁹ New section 304(c)(2)(A) provides that section 304(a) will also apply when stock of a corporation is transferred to a newly formed holding company by shareholders who control the holding company after such a transfer, provided that a distribution of property by the holding company accompanies the transfer.¹³⁰ Thus

¹²⁷ See *id.* at § 226, 96 Stat. at 490-92.

¹²⁸ See I.R.C. § 304(b)(3)(C) (1982).

¹²⁹ See I.R.C. § 304(b)(3)(A) (1982) ("Except as otherwise provided in this paragraph, subsection (a) (and not [sections 351 and 357]) shall apply to any property received in a distribution described in subsection (a)."). Section 317(a) (1982) defines "property" to mean "money, securities and any other property; except that such term does not include stock in the corporation making the distribution." Thus, if bank shareholders transferred bank stock to a bank holding company in exchange for stock in the bank holding company, and the assumption by the holding company of the indebtedness incurred and owing by those shareholders in connection with their acquisition of bank stock, the distribution of holding company stock to the bank shareholders would be governed by § 351 and not § 304. See H.R. REP. No. 760, 97th Cong., 2d Sess. 409, 542, reprinted in 1982 U.S. CODE CONG. & AD. NEWS 1190, 1316 [hereinafter cited as H.R. REP. No. 760]. Absent a special statutory provision addressing the treatment under § 304 of the assumption of indebtedness, that assumption by the holding company would constitute a distribution of "property." See *Maier v. Commissioner*, 469 F.2d 225 (8th Cir. 1972); Rev. Rul. 78-422, 1978-2 C.B. 129.

¹³⁰ I.R.C. § 304(c)(2)(A) (1982). See also B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 9.33 (4th ed. Supp. 1983) ("New § 304(c)(2) also makes clear that § 304(a)(1) applies to the creation of a new controlled corporation (rather than being limited to transactions involving the stock of existing brother-sister corporations), even though some of the

TEFRA makes clear that section 304(a) could apply to the transfer of bank stock to a newly created holding company even though the transferring shareholders were not in "control" of the bank and the holding company prior to such transfer.

Although section 304 will now override section 351 in a transaction described in both sections which involves a distribution of property, section 304(a) will not apply to the assumption of indebtedness by a transferee corporation in a transaction if such liability was incurred by a shareholder to purchase shares of one controlled corporation which are transferred to another controlled corporation.¹³¹ Section 304(a) will also not apply if the stock of one corporation is transferred to a commonly controlled corporation subject to the indebtedness incurred to purchase those shares.¹³² Such an assumption of indebtedness will be governed instead by sections 351 and 357.¹³³ While the statute makes clear that for section 304 purposes, indebtedness includes an "extension," "renewal" or "refinancing" of that indebtedness,¹³⁴ those terms

transferees receive only stock in the transferee corporation." I.R.C. § 304(c)(2)(B) (1982) now provides:

Where 2 or more persons in control of the issuing corporation transfer stock of such corporation to the acquiring corporation and, after the transfer, the transferees are in control of the acquiring corporation, the person or persons in control of each corporation shall include each of the persons who so transfer stock.

Thus, § 304 will now apply to any distribution of "property" received by a shareholder, even though that shareholder is not in control of either of the two corporations, if that minority shareholder transfers stock of Corporation A to Corporation B as part of a transaction in which shareholders who did control Corporation A transferred their stock in Corporation A to Corporation B and were in control of Corporation B after the transaction. Prior to TEFRA, it was unclear whether § 304 applied to such a minority shareholder in addition to shareholders who were in control of both Corporation A and Corporation B.

¹³¹ See I.R.C. § 304(b)(3)(B)(i) (1982) ("Subsection (a) shall not apply to any liability—(I) assumed by the acquiring corporation, or (II) to which the stock is subject, if such liability was incurred by the transferor to acquire the stock."). Thus, § 304 does not exclude the assumption of indebtedness from the definition of "property" but is merely inapplicable to such debt assumptions.

¹³² See I.R.C. § 304(b)(3)(B)(i)(II) (1982).

¹³³ H.R. REP. NO. 760, *supra* note 129, at 542, U.S. CODE CONG. & AD. NEWS at 1316 ("However, section 304 will not apply to debt incurred to acquire stock of an operating company and assumed by a controlled corporation acquiring the stock since assumption of such a debt is an alternative to debt-financed direct acquisition by the acquiring company.").

¹³⁴ See I.R.C. § 304(b)(3)(B)(ii) (1982).

are not defined and the Act's legislative history is likewise silent.

The constraints imposed on the tax-free assumption of "acquisition indebtedness" by a bank holding company in Revenue Ruling 80-240 and Revenue Procedure 80-34 are not contained in section 304, as amended by TEFRA.¹³⁵ Now under section 304, the transferring shareholder need not have incurred the indebtedness as agent for a bank holding company, nor must the indebtedness be assumed by the holding company within a specified period of time after it was incurred.¹³⁶ Thus, "old and cold" indebtedness can be assumed by the holding company without triggering the application of section 304(a). In addition, prior to the transfer to the holding company, a shareholder may exercise the incidents of ownership of the bank stock to be transferred without jeopardizing the tax-free status of the assumption of the indebtedness incurred in connection with the shareholder's purchase of those shares. Under Revenue Ruling 80-240, the receipt of dividends by the shareholder/agent, for example, was arguably inconsistent with the shareholder's status as mere agent.¹³⁷ Likewise, if a shareholder remained liable for the assumed indebtedness as a guarantor, the agency status required by Revenue Ruling 80-240 could have been jeopardized.¹³⁸ Although TEFRA and its legislative history are silent on these points, the amendments to section 304 allowing tax-free debt assumption are not based on an agency theory and appear to assume that the transferring shareholder owns outright the shares encumbered by the indebtedness to be transferred.¹³⁹

¹³⁵ See text accompanying notes 91-97 *supra* for a discussion of Rev. Rul. 80-240 and Rev. Proc. 80-34.

¹³⁶ See Rev. Proc. 80-34, 1980-2 C.B. 768 for the timing and proof requirements to show agent status and avoid liability under §§ 304(a)(1) and 357(a).

¹³⁷ See Rev. Rul. 80-240, 1980 C.B. 116, 117; Rev. Proc. 80-34, 1980-2 C.B. 768.

¹³⁸ See Rev. Proc. 80-34, 1980-3 C.B. 768.

To [establish status as a mere intermediary agent] the taxpayer must submit to the Internal Revenue Service documented evidence, composed at the time the liability was incurred, which indicates that the unrelated lender had agreed to release the transferor-borrower from *any and all obligation* on the liability in favor of the corporate transferee.

Id. (emphasis added).

¹³⁹ I.R.C. § 304(b)(3)(B).

By providing a blanket exclusion for the assumption of acquisition indebtedness from the coverage of section 304, Congress, apparently through inadvertence, has given a shareholder the opportunity to accomplish indirectly a result which that shareholder cannot achieve directly by virtue of the U.S. Supreme Court's ruling in *United States v. Davis*.¹⁴⁰

In *Davis*, the taxpayer owned 25% of the common stock of a corporation. His wife and two children also each owned 25% of the common stock. In addition, the taxpayer had owned 100% of the preferred stock of the corporation, which was redeemed by the corporation.¹⁴¹ The lower court had held that the redemption should be viewed, for tax purposes, as a purchase of the stock under section 302(b)(1) and not as a dividend distribution under section 301.¹⁴² The Supreme Court reversed and held that the constructive ownership rules of section 318 should apply in determining whether a redemption was equivalent to a dividend under section 302(b)(1).¹⁴³ The Court also held that a partial redemption of a sole shareholder would always be equivalent to a dividend, even for a shareholder who, like the *Davis* taxpayer, was a "sole" shareholder by virtue of the attribution of his family's shares to him pursuant to section 318.¹⁴⁴ The partially redeemed shareholder will, after the redemption, through his share ownership and that of his family, continue to own 100% of the corporation.¹⁴⁵ Thus, the taxpayer in *Davis* received a distribution from a corporation without suffering any diminution in his constructive ownership of the corporation.¹⁴⁶ Therefore, reasoned the Court, dividend treatment for the redemption distribution was appropriate.¹⁴⁷

¹⁴⁰ 397 U.S. 301 (1970).

¹⁴¹ *Id.* at 303.

¹⁴² 274 F. Supp. 466, 471 (M.D. Tenn. 1967) (citing *Keefe v. Cote*, 213 F.2d 651 (1st Cir. 1954)). The court thought *Keefe* reintroduced the "legitimate corporate purpose" test. Such a purpose would protect a redemption from classification as "essentially equivalent to a dividend." *Id.* at 470.

I.R.C. § 302(b)(1) provides that a distribution in a stock redemption shall be treated as a distribution in payment for the exchange of the stock if "the redemption is not essentially equivalent to a dividend." I.R.C. § 301(a), (c) provides that, except as otherwise provided in subchapter C of the Code, a distribution of property by a corporation with respect to its stock is a dividend.

¹⁴³ *Id.*

¹⁴⁴ *See id.* at 313.

¹⁴⁵ *Id.*

¹⁴⁶ *See id.*

¹⁴⁷ *See id.*

Under the TEFRA amendments, a shareholder could sell a portion of his or her shares of a controlled corporation stock at a gain to a family member, who would purchase those shares for cash with borrowed money.¹⁴⁸ The selling shareholder would receive cash which would be accorded capital gain treatment, assuming the selling shareholder met the requirements for capital gain treatment.¹⁴⁹ The purchasing shareholder could then transfer those shares to a holding company in a transaction described in section 351 and receive in exchange shares of holding company stock and the assumption of the indebtedness incurred by the purchasing shareholder to buy those shares.¹⁵⁰ In economic terms, the effect of such a transaction is the same as the redemption in *Davis*. The selling shareholder has received a distribution of money the repayment of which will be made indirectly from earnings and profits of the corporation.¹⁵¹ Yet the selling shareholder's family would have suffered no diminution in its percentage control of the corporation. Under the TEFRA amendments, such a transaction would not be governed by section 304(a). The sale of the stock to the family member would not be governed by section 351 or section 304 because it would not involve transfers to or from a corporation. The subsequent transfer of the stock and assumption of the indebtedness would, however, be governed by the TEFRA amendments and, under new section 304(b)(3)(B)(i), would be tax-free under sections 351 and 357.

Congress has apparently realized the possibility for circumventing the *Davis* doctrine under the TEFRA amendments, and has sought to correct the problem in the Tax Reform Act of 1983 (TRA).¹⁵² TRA would exclude the assumption of "acquisition in-

¹⁴⁸ See Ginsburg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 177 (1983) for a sardonic appraisal of TEFRA's probable impact on corporate acquisitions. Ginsburg writes: "New section 304(b)(3)(B) has tunnel vision. Focused on the existence of acquisition indebtedness, it does not care at all that the debt arose in a sale between related persons." *Id.* at 180-81.

¹⁴⁹ See I.R.C. § 1221.

¹⁵⁰ See Ginsburg, *supra* note 148, at 181 for a description of how the TEFRA amendments have circumvented the holding in *Davis*.

¹⁵¹ The holding company would probably obtain the funds to retire the assumed indebtedness from dividends received on the stock of the corporation which it owned.

¹⁵² REPORT OF THE COMMITTEE ON WAYS AND MEANS, H.R. DOC. NO. 4170, 98th Cong., 1st Sess. 8 (1983) [hereinafter cited as TRA].

debtedness" from the operation of section 304 only if the stock which is the subject of the indebtedness was purchased "from a person none of whose stock is attributable to the transferor under section 318(a)." ¹⁵³ Thus, under TRA, assumed acquisition indebtedness, originally created in a sale between two parties the ownership of whose shares would be attributed to each other under section 318(a), would constitute a distribution of property subject to the provisions of section 304(a). ¹⁵⁴

Section 226 of TEFRA, like the Recommendation of the ABA Section of Taxation, ¹⁵⁵ provides that debt instruments and other such securities do constitute property for purposes of section 304. ¹⁵⁶ Congress did, however, give recognition to the unique nature of bank acquisitions involving the formation of a bank holding company by providing a limited safe harbor for the use of such securities. ¹⁵⁷ In a transaction of the type described in Figure C, new section 304(b)(3)(c) provides that section 304(a) will not apply to the receipt of any security incident to the formation of a bank holding company by a "qualified minority shareholder" if the following conditions are met: (1) control of a bank is acquired, pursuant to a plan, and within two years after such control is acquired, stock constituting control of the bank is transferred to a

¹⁵³ *Id.* at 320.

¹⁵⁴ *See id.*

¹⁵⁵ See text accompanying notes 105-25 *supra* for a discussion of the ABA Section of Taxation Recommendation.

¹⁵⁶ *See* I.R.C. § 304(b)(3)(B).

¹⁵⁷ The issuance of holding company preferred stock to exchanging bank shareholders in a holding company formation of the type described in Figure C will not constitute a distribution of property, as defined in I.R.C. § 317. Thus, the provisions of § 304(b)(3)(c) would not apply to the issuance of preferred stock to shareholders. Section 351, and not § 304, will apply to the distribution of that preferred stock.

Section 226 of TEFRA did, however, amend § 306 of the Code to provide that such non-common stock issued in connection with a § 351 transaction will be "§ 306 stock" if, had cash been issued in lieu of such stock, dividend treatment pursuant to § 304 would result to any extent. *See* I.R.C. § 306(c)(3) (1982). In a Figure C holding company formation the distribution of cash by the holding company would probably result in dividend treatment under § 304, as amended by TEFRA. Thus, the holding company preferred stock would be § 306 stock. Once characterized as § 306 stock, gain from the later sale or redemption of a portion of that stock will generally produce ordinary income rather than a capital gain. Section 306 was enacted to prevent a bailout of corporate earnings at the capital gains rate by the issuance and later sale or redemption of preferred stock. *See* B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 10.02.

bank holding company in connection with its formation; (2) there is a distribution of property under section 304(a) incident to the formation of the holding company; and (3) the shareholders of the holding company who receive distributions of the property do not have control of the holding company.¹⁵⁸ In the case of bank holding companies formed before 1985, the requirements set out in (1) above are inapplicable.¹⁵⁹ "Qualified minority shareholder" is defined by new section 304(b)(3)(D)(i) to be a shareholder who owns less than 10% in value of the bank holding company's stock, including others whose share ownership is attributed to that shareholder.¹⁶⁰ The constructive ownership rules of section 318 must be consulted in calculating the share ownership of qualified minority shareholders.¹⁶¹

It is unlikely, however, that new section 304(b)(3)(C) facilitates the formation of bank holding companies. In most instances involving a distribution of holding company securities, there will have been at least two separate distributions of property described in section 304(a). The assumption of indebtedness from the control shareholders falls within the literal definition of distribution of property under section 304(a), even though such a distribution is excepted from section 304(a) by virtue of new section 304(b)(3)(B).¹⁶² In addition, the distribution of the bank holding company securities is itself a distribution of property described in section 304(a).¹⁶³ In the typical bank acquisition/bank holding company formation outlined above, the control group would have its acquisition indebtedness assumed by the holding company. Thus, condition (3) above would not be satisfied and, presumably, section 304(a) would apply to the receipt of the holding company

¹⁵⁸ I.R.C. § 304(b)(3)(C) (1982). TEFRA is silent regarding the definitions of the words "plan" and "security" for purposes of § 304. See B. BITTKER & J. EUSTICE, *supra* note 60 at ¶¶ 3.04, 4.11 for a discussion of the various definitions given those words under other provisions of the Code.

¹⁵⁹ I.R.C. § 304(b)(3)(D)(iii) (1982).

¹⁶⁰ See I.R.C. § 304(b)(3)(D)(i) (1982).

¹⁶¹ I.R.C. § 304(c)(3). This subsection applies the constructive ownership rules of I.R.C. § 318 without regard to the 50% limitation contained therein.

¹⁶² I.R.C. § 304(b)(3)(B) excludes a corporation's assumption of liability from the coverage of § 304(a) if the transferor assumes liability in order to purchase the stock.

¹⁶³ I.R.C. § 304(a). "Property" is defined in I.R.C. § 317(a) as "money, securities and any other property." The distributing corporation's stock or "rights to acquire such stock," do not constitute property. See I.R.C. § 317(a).

securities by qualified minority shareholders. It is doubtful that Congress intended such a result. More likely, Congress intended that section 304(a) would not apply to the receipt of bank holding company securities in connection with the formation of that bank holding company so long as those shareholders who received debt securities, in the aggregate, did not have control of the bank holding company for purposes of section 304.

The Internal Revenue Service has stated informally that for private letter ruling purposes new section 304(b)(3)(C) will be read literally. Thus, the Service will apparently refuse to issue private letter rulings approving the tax free receipt of holding company securities by qualified minority shareholders, where the holding company also assumes acquisition indebtedness of shareholders who will be in control of the holding company for section 304 purposes. This position, while perhaps technically correct, appears to fly in the face of the obvious intent of the TEFRA amendments to section 304. Inasmuch as holding company securities would probably rarely be used in any holding company formation other than one in which they are being used to equalize shareholders with shareholders who are having debt assumed, the Service's position has made the drafting of new section 304(b)(3)(C) an exercise in futility.¹⁶⁴

Language in TRA would correct the imprecise drafting of new section 304(b)(3)(C). According to TRA, the assumption of, or acquisition of stock subject to, acquisition indebtedness will not constitute a distribution of property.¹⁶⁵ If that proposal becomes law, then sections 351 and 357 rather than section 304(a) will apply to the receipt of bank holding company securities by qualified minority shareholders in connection with the formation of the holding

¹⁶⁴ The issuance of holding company securities is not the only method of equalizing the economic positions of the shareholders. It may, however, be the equalization method with the fewest attendant unfavorable results. Holding company preferred stock could be issued to all shareholders not having debt assumed, but such preferred stock will likely be "§ 306 stock." See note 163 *supra* for a description of I.R.C. § 306. Alternatively, each shareholder having indebtedness assumed could allow his or her equity investment in the holding company to be diminished by the amount of the debt assumed by the holding company from the shareholder. The shareholders having indebtedness assumed are usually control shareholders of the bank and probably would not desire to have their percentage ownership of the holding company diminished.

¹⁶⁵ TRA, *supra* note 152, at 320.

company, as long as the qualified minority shareholders, in the aggregate, do not control the bank holding company for section 304 purposes.¹⁶⁶

Section 226 of TEFRA also amended section 304 in an effort to solve the problem of determining how much, if any, of a distribution of property described in section 304(a) constitutes a dividend. Under new section 304(b)(2), "the determination of the amount which is a dividend shall be made as if the property were distributed by the issuing corporation to the acquiring corporation and immediately thereafter distributed by the acquiring corporation."¹⁶⁷ In the case of a bank holding company formation involving a distribution of property such as the issuance of holding company debt securities to non-qualifying minority shareholders, the distribution will be treated as though the property were first distributed from the bank to the holding company and then immediately distributed from the holding company to its shareholders.¹⁶⁸

The drafters of new section 304(b)(2) no doubt intended that it would cause the entire amount of such a distribution of property to be characterized as a dividend. The drafters probably believed that the imputed distribution from the bank to the holding company would give the holding company earnings and profits in the amount of the distribution, thus making dividend characterization of the distribution unavoidable.¹⁶⁹ But under a literal reading of new section 304(b)(2), such would not be the case.

Under section 301(b)(1)(B), the amount of a distribution from one corporation to another (for all property other than cash) is deemed to be the lesser of the fair market value of the property or the adjusted basis of the property in the hands of the distributing corporation, increased by any gain the distributing corporation recognized with respect to such distribution.¹⁷⁰ If a bank holding company distributed debt securities to non-qualified minority shareholders in connection with its formation, the distribution

¹⁶⁶ See *id.*

¹⁶⁷ I.R.C. § 304(b)(2).

¹⁶⁸ See I.R.C. § 304(b)(2)(A).

¹⁶⁹ I.R.C. § 316(a)(1) defines "dividend" as any distribution of property made by a corporation to its shareholders out of its accumulated or current earnings and profits.

¹⁷⁰ See I.R.C. § 301(b)(1)(B)(ii).

would be treated under new section 304(b)(2) as though the bank distributed those securities to the holding company, which immediately thereafter distributed them to its shareholders. The bank would have no basis in the securities, because it provided no consideration for them, and thus under section 301(b)(1)(B) the amount of the distribution to the holding company would be zero.¹⁷¹ Because the holding company would have no earnings and profits, the distribution of its securities would not be classified as a dividend.¹⁷² Obviously, this was not the intent of Congress.

TRA attempts to resolve, by clarifying congressional intent, the problem of determining what portion of a distribution of property should be treated as a dividend.¹⁷³ Under the revisions to new section 304(b)(2) contained in TRA, in determining the portion of a distribution of property by the acquiring corporation (the holding company) which constitutes a dividend, the distribution would be viewed as having been made to the shareholder by the acquiring corporation to the extent of that corporation's earnings and profits.¹⁷⁴ The amount of the distribution which exceeds the amount of earnings and profits of the acquiring corporation would, under TRA, be treated as a distribution by the issuing corporation (the bank) to the shareholder to the extent of the issuing corporation's earnings and profits.¹⁷⁵ Thus, the earnings and profits of the acquired corporation and issuing corporation would be combined, under TRA, to determine the amount of a distribution of property to be accorded dividend treatment. If, in a bank holding company formation, a bank shareholder exchanged his or her shares

¹⁷¹ See I.R.C. § 301(b)(1)(B).

¹⁷² See I.R.C. § 316.

¹⁷³ See TRA, *supra* note 152, at 319. Title VI of TRA consists of "technical corrections" to TEFRA. Section A (11), entitled "Treatment of certain holding companies," deals with §§ 304 and 306 of the Code, as revised by TEFRA.

Under TEFRA § 226(a)(3)(A) (currently codified at I.R.C. § 304(b)(2)(A)), dividend calculation "is made as if the property were distributed from the issuing corporation to the acquiring corporation and then from the acquiring corporation to the shareholders." See TRA, *supra* note 152, at 318-19. The Comments explain that TEFRA § 226(a)(3)(A) was designed to include the aggregate earnings and profits of both the acquiring and issuing corporations in determining dividend amounts to a property receiving shareholder. In practice, the Comments assert, dividend treatment has varied, depending on whether a corporate or non-corporate shareholder is involved.

¹⁷⁴ See TRA, *supra* note 152, at 319.

¹⁷⁵ See *id.*

of bank stock for holding company stock and a short term holding company promissory note for example, the distribution of the note would likely be viewed as a dividend under sections 301 and 316 to the extent of the earnings and profits of the bank *and* the holding company. The bank's earnings and profits would be used for measuring the amount of the dividend, even though the holding company, not the bank, issued the note (distributed property).

Under the proposed TRA amendment to section 304(b)(2), the shareholders of a newly formed bank holding company will no longer be able to escape section 304(a) and dividend treatment by causing the holding company to elect a short first taxable year which would reflect no earnings and profits. In addition, it appears likely that the shareholder will realize gain, if any, for tax purposes, at the time of the property distribution in a bank holding company formation.

Although hampered by certain ambiguities caused by poor drafting, section 226 of TEFRA has provided a clear resolution to the 304/351 overlap problem.¹⁷⁶ The anomalies that remain should be corrected by the TRA amendments to section 304. Nevertheless, the IRS, in recent formal and informal pronouncements, has injected another element of uncertainty into the planning of bank holding company formations which fit the 304/351 pattern.

VI. THE CONTINUITY OF INTEREST PROBLEM

In Revenue Ruling 80-284,¹⁷⁷ the IRS ruled that a section 351 transaction will be subject to the shareholder "continuity of interest" requirement applicable to acquisitive reorganizations if the section 351 transaction is part of a larger transaction that resembles a reorganization.¹⁷⁸

The fact situation of Revenue Ruling 80-284 can be briefly summarized as follows: A, an individual, owned 14% of the outstanding stock of T Corporation. The remaining 86% of the outstanding stock was publicly held. P, a corporation, desired to purchase the stock of T Corporation and thereafter operate T Corporation's

¹⁷⁶ See B. BITTKER & J. EUSTICE, *supra* note 60, at ¶ 9.33 (4th ed. Supp. 1983).

¹⁷⁷ 1980-2 C.B. 117.

¹⁷⁸ *Id.* at 118. The Service declared: "[V]iewed from the perspective of all the parties, the larger transaction fits a pattern common to acquisitive reorganizations." *Id.*

business as a wholly-owned subsidiary of P Corporation. A had a low basis in his T Corporation stock and was unwilling to sell his stock for cash because such a sale would require him to recognize taxable gain. The owners of the remaining 86% of the T Corporation stock were, however, willing to accept cash for their T Corporation stock. To provide for the transfer of A's stock without gain recognition, P Corporation and A agreed to organize S Corporation, to be a wholly-owned subsidiary of P Corporation, to acquire and hold A's T Corporation stock. P Corporation exchanged cash for S Corporation common stock. A exchanged his shares of T Corporation stock for all of S Corporation's preferred stock. The parties intended that this exchange would be tax-free under section 351.

Thereafter, as part of an overall plan, S Corporation formed a subsidiary, D Corporation. S Corporation exchanged cash for D Corporation common stock. D Corporation then merged with and into T Corporation. The shareholders of T Corporation, other than S Corporation, received cash from D Corporation for their T Corporation stock. The T Corporation stock was cancelled, and each share of D Corporation stock (all of which was owned by S Corporation) was converted, pursuant to state law, into new shares of T Corporation stock.

After the transaction S Corporation was a holding company, owning 100% of the stock of T Corporation. T Corporation continued its business as a subsidiary of S Corporation. P Corporation owned all of the common stock of S Corporation, and A owned all of the S Corporation preferred stock. Because the entire transaction described in Revenue Ruling 80-284 resembled a reorganization in which P Corporation would have acquired S Corporation, the IRS held that the entire transaction was subject to the reorganization continuity of interest rule.¹⁷⁹

The continuity of interest rule requires that a portion of the shareholders of a corporation, the stock or assets of which are acquired in a reorganization, continue as shareholders in the acquiring corporation after the acquisition.¹⁸⁰ This doctrine is not made ex-

¹⁷⁹ See *id.* at 118-19.

¹⁸⁰ See *id.* at 117. For a discussion of the continuity of interest requirement as it relates to reorganizations, see B. BITTKER & J. EUSTICE, *supra* note 60 at ¶ 14.11.

PLICIT in the Internal Revenue Code; the rule was developed by the courts in interpreting and applying the reorganization sections of the Code.¹⁸¹ For private letter ruling purposes the Internal Revenue Service has stated that in a reorganization there must be a continuing stock ownership in the acquiring corporation by former shareholders of the acquired corporation equal in value to at least 50% of the value of the stock of the acquired corporation immediately before the reorganization.¹⁸² The Service has also made a formal decision not to issue advance private letter rulings concerning "reorganization-type" section 351 transactions unless the continuity of interest rule is satisfied.¹⁸³

The Service has stated informally that the purchase of 80% or more of a bank's stock by individuals, followed by the transfer of that stock to a newly organized bank holding company in exchange for bank holding company stock, is a transaction that resembles a reorganization and thus, at least for private letter ruling purposes, will be subject to the continuity of interest rule applicable to reorganizations.¹⁸⁴ Apparently, only those who are deemed to be "historic" shareholders of the bank will be considered by the Service to be shareholders of the acquired corporation (the bank) for continuity of interest purposes. Informally, the Service has indicated that to qualify as an "historic" shareholder one must have held bank stock for at least two years.¹⁸⁵ Thus, for private letter ruling purposes, if an individual who was not previously a shareholder buys 80% of the bank's stock and soon thereafter

¹⁸¹ "Reorganization" is defined by I.R.C. § 368(a)(1) (1982) to include the seven types of corporate restructuring designated therein. A typical bank holding company formation involving the purchase of 80% or more of a bank's stock by an individual or group, followed by an exchange of the stock of the bank for bank holding company stock and the assumption of the acquisition indebtedness by the holding company, is not described by any of the designated types. *See also* Treas. Reg. § 1.368-1(b) (1980).

¹⁸² *See* Rev. Proc. 83-22, 1983-13 I.R.B. 73, 76. *See also* Recommendation, *supra* note 105, at 1446-51. Although the IRS requires a 50% continuity for advance private letter rulings for reorganizations, courts that have considered the issue allow a much lower figure. *See, e.g.,* John A. Nelson Co. v. Helvering, 296 U.S. 374, 377 (1935) (controlling interest in transferee corporation not required; 38% continuity sufficient). Indeed, 25% continuity has been deemed sufficient. *See, e.g.,* Miller v. Commissioner, 84 F.2d 415, 418 (6th Cir. 1936).

¹⁸³ *See* Rev. Proc. 83-22, 1983-13 I.R.B. 74, 76.

¹⁸⁴ *See Tax Clinic*, 14 TAX ADVISOR 219, 219-20 (1983).

¹⁸⁵ *Id.*

transfers that stock to a bank holding company, there will not be sufficient continuity of interest. The Service will not approve such a transaction in an advance private letter ruling, even if it complies with the statutory provisions of section 351 and the provisions of TEFRA.

The application of the continuity of interest rule could result in a tax disaster for the individual or group who purchases 80% or more of the stock of a bank and transfers that stock to a holding company in exchange for holding company stock and the assumption of acquisition indebtedness by the holding company. The Service could assert that section 304(b)(3)(B), which provides that section 304(a) will not apply to an assumption of acquisition indebtedness, is applicable only in transactions otherwise governed by section 351. If the continuity of interest rule applies to section 351 transactions and if the transaction does not satisfy the continuity of interest rule, the transaction is arguably not governed by section 351. Thus, section 304(b)(3)(B) would not apply and the assumption of indebtedness would be governed by section 304(a). As stated above, there is substantial risk of dividend treatment such as ordinary income recognition if section 304(a) is applicable to the transaction.

The continuity of interest position taken by the Service with regard to section 351 transactions is inconsistent with the clear intent of Congress to provide for tax-free treatment of the assumption of indebtedness in typical one-bank holding company formations. Moreover, the continuity of interest requirement for section 351 transactions is at odds with the Service's position in Revenue Ruling 80-240.

In Revenue Ruling 80-240, discussed above,¹⁸⁶ the Service held that the exchange of 100% of the bank stock, which had been recently purchased, for holding company stock constituted a tax-free transaction under section 351.¹⁸⁷ That transaction would not, however, satisfy the continuity of interest rule as interpreted by the Service and adopted in Revenue Ruling 80-284.¹⁸⁸ The Service,

¹⁸⁶ See notes 91-93 *supra* and accompanying text.

¹⁸⁷ See Rev. Rul. 80-240, 1980-2 C.B. 117.

¹⁸⁸ *Id.* at 118. The Service refers in Rev. Rul. 80-284 to case law which refined the "continuity of interest" test. *Id.* *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951), contains a two-part test for showing

again informally, has stated that Revenue Ruling 80-284 "impliedly revoked" Revenue Ruling 80-240 despite the fact that Revenue Ruling 80-284 makes no mention of Revenue Ruling 80-240. Yet the Service has, as of this writing, taken no formal action to revoke or rescind Revenue Ruling 80-240.¹⁸⁹

Obviously, formal action is needed by the Service to clarify its position and intentions regarding the applicability of the continuity of interest rule to typical bank holding company formations. In the interim, however, the certainty that Congress intended to provide in section 226 of TEFRA to bankers and their lawyers and accountants in connection with bank holding company formations will be largely illusory.

CONCLUSION

The federal income tax consequences of a bank holding company formation are an important consideration in the planning of such a transaction. Yet, during the past decade, the federal income tax treatment of many such formations has been uncertain. The courts and the Internal Revenue Service have attempted to bring predictability and certainty to the 304/351 area, but with no real success. Congress, however, sought to bring some measure of certainty to the area with the enactment of section 226 of TEFRA. Section 226 signals bankers that the formation of bank holding companies in situations similar to that described in Figure C can be accomplished without adverse tax treatment for bank shareholders who participate in the transaction. Nevertheless, in light of the ambiguities of section 226 and the uncertainty engendered by the position of the Internal Revenue Service concerning a continuity of interest requirement in section 351, investors and lawyers will derive little security from section 226.

Because the Internal Revenue Service has continued to adhere to its continuity of interest position after TEFRA, it appears that

continuity of interest: "(1) [T]hat the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by the material interest in the affairs of the transferee corporation, and (2) that such retained interest represents a substantial part of the value of the property transferred." *Id.*

¹⁸⁹ Predictably, the IRS's continuity of interest position has been criticized by tax commentators. See, e.g., Bloom, *The Stark Reality of the New Liquidation and Redemption Rules*, 10 J. CORP. TAX'N 34-35 (1983); Ginsburg, *supra* note 148, at 190.

Congress must act once again to clarify the requirements of sections 351 and 304. Congress has an opportunity to address the issue in TRA in connection with the technical corrections to section 226 of TEFRA contained in that proposal. Congress should seize this opportunity to clarify the uncertainties of section 226, resolve the continuity of interest problem, and thereby finally provide the guidance that bankers, investors and their advisors need.

Author's Note: As this Article was being printed, the Internal Revenue Service issued Rev. Rul. 84-71, 1984-19 I.R.B. 6, which revoked Rev. Rul. 80-284, 1980-2 C.B. 117. The Service announced in Revenue Ruling 84-71 that a transaction literally governed by § 351 and that is a part of a "larger acquisitive transaction" will not be viewed as a transaction subject to the reorganization continuity of interest rules. See also Rev. Proc. 84-43, 1984-13 I.R.B.

Also, on July 18, 1984, Congress enacted the Deficit Reduction Act of 1984 ("DRA"). Section 712 of DRA contained amendments to section 304 similar to those proposed in the Tax Reform Act of 1983.

Section 712 amended section 304(b)(3) to provide that the assumption of acquisition indebtedness will be excluded from the coverage of section 304(a) only if the stock which is the subject of the indebtedness was acquired by the transferor (1) from a person "none of whose stock is attributable to the transferor under section 318(a) (other than paragraph (4) thereof)" or from a person who satisfies rules similar to the rules set forth in section 302(c)(2) concerning a complete termination of interest in a corporation with regard to the acquiring (the bank holding company) and issuing (the bank) corporations. See text accompanying notes 140-154 supra.

Section 304(b)(2), as amended by section 712 of DRA, now provides that the determination of the amount of a dividend for purposes of section 304 will be made as if property were first distributed to a shareholder by the acquiring corporation (the bank holding company) to the extent of its earnings and profits and then by the issuing corporation (the bank) to the extent of its earnings and profits. See text accompanying notes 167-175.

Section 712 also amended section 304(b)(3)(C) to make clear

that the assumption of acquisition indebtedness by a bank holding company in a bank holding company formation described in section 351 does not constitute a distribution of property for purposes of section 304. See text accompanying notes 165 and 166 supra.

