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Brenda D. Crocker

Michael L. Unti

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Crocker and Unti: Reorganizing an Insolvent Savings and Loan

I.R.C. § 368(a)(3)(D): REORGANIZING AN INSOLVENT SAVINGS AND LOAN ASSOCIATION

by

BRENDA D. CROCKER and MICHAEL L. UNTI**†

I. INTRODUCTION

UNTIL RECENT months the savings and loan industry enjoyed a strong present and a promising future. Brought into its own during the Great Depression to relieve homeowners of oppressive mortgage market conditions,¹ the post-World War II industry became the backbone of the residential mortgage market.² Despite its continued dominance in this market,³ however, the pressures of severe inflation threaten its viability.

As a financial intermediary, the savings and loan institution exists to enable saving customers⁴ to earn interest or dividends on their deposits and to provide borrowing customers with economical residential mortgage financing.⁵ The institution's principal source of funds is its depositors, while its primary source of income traditionally has been interest received on mortgage loans. As the real rate of inflation has risen, however, the source

*Staff Clerk, United States Court of Appeals for the Fourth Circuit; J.D., 1980, Washington and Lee University; B.A., 1971, Agnes Scott College.

**Associate, Hunton & Williams, Richmond, Virginia; J.D., 1981, Washington and Lee University; M.A., M.Ph., 1974, Yale University; B.A., 1972, Washington and Lee University.

†The opinions expressed by the authors are entirely their own and in no way reflect the views of their employers.

¹ J. BOYKIN, *FINANCING REAL ESTATE* 39 (1979). Congress passed the Home Owners' Loan Act in 1933. 12 U.S.C. §§ 1461-64 (1980). Essentially, its purpose was

(t)o provide emergency relief with respect to home mortgage indebtedness, to refinance home mortgages, to extend relief to the owners of homes occupied by them and who are unable to amortize their debt elsewhere, to amend the Federal Home Loan Bank Act, to increase the market for obligations of the United States and for other purposes.

Home Owner's Loan Act of 1933, Preamble, 48 Stat. 128 (1933).

² See J. BOYKIN, *supra* note 1, at 29-57. See generally L. KENDALL, *THE SAVING AND LOAN BUSINESS* (1962).

³ In 1972 the number of savings and loan associations had reached 5317. See A. Stafford, *1972 Statistical Report for Savings Associations*, in 1973 *SAVINGS AND LOAN ANNALS* 250, 251-55 (1974). In 1977, these associations held approximately \$383.05 billion in residential real estate debt (1-4 family dwellings), compared with \$105.11 billion held by commercial banks and \$11.39 by FHA. 66 FED. RES. BULL., Chart A41 (May, 1980). At the end of 1979, savings and loan holdings had increased by \$90.3 Billion, while commercial bank holdings had increased by only \$40.96 billion and FHA by \$3.49 billion. *Id.*

⁴ A saving customer may be an owner, depending upon the terms under which the savings and loan association received its initial operating capital. If the institution is a mutual association, the depositors are the owners to the extent of their deposits. If the institution is a stock association, the owners are the holders of the capital stock and the depositors are customers.

⁵ For congressional intent behind the statute creating federally-chartered savings and loan associations, see *supra* note 1. State statutes establishing state-chartered savings and loan associations contain similar language. See, e.g., N.J. STAT. ANN. 17:12A-11. (West 1963) (purpose of savings and loan association is promoting "thrift, home ownership and housing").

of funds has declined, as depositors have sought out short-term, higher-yield securities in preference to the longer term, lower-yield investments offered by savings and loan associations.⁶ In addition, as the real rate of inflation has increased, the institution's real income has diminished by the decreased value of outstanding mortgage loans.⁷

During recent months the savings and loan industry has suffered record losses.⁸ Aware of the severe impact of continued financial trauma,⁹ Congress included in the Economic Recovery Act of 1981 the "all-savers certificate" provision¹⁰ and a new savings and loan association insolvency reorganization provision.¹¹ The former section was designed to attract new

⁶ See ABA SECTION OF REAL PROPERTY, FINANCING REAL ESTATE DURING THE INFLATIONARY 80's, 23 (1981); Downs, *Real Interest Rates Short-Change Lenders*, NATIONAL REAL ESTATE INVESTORS 26 (Oct. 1980). Moreover, as inflation causes money to become more expensive, loan prepayments decrease thereby further constricting the pool of loanable funds. R. FISHER, MORTGAGE REPAYMENTS AS A SOURCE OF LOANABLE FUNDS 15-16, Chart 4-5 (1971).

⁷ The contract rate, the rate at which the institution makes the loan with the mortgage, minus the real rate of inflation equals the real rate of interest earned on the loan. See Downs, *supra* note 6.

⁸ The Federal Home Loan Bank Board report on federally-chartered savings and loan associations for the period covering January to June, 1981 shows that nearly 70% of those institutions suffered a decrease in net worth (assets minus liabilities). During the prior six months approximately 35% suffered losses. Wall Street Journal, Sept. 29, 1981, at 10. Moreover, the report indicated that the average cost of funds in the industry was 10.31% while the average earnings on home loans was 9.72%. *Id.* Board Chairman Richard T. Pratt almost simultaneously announced that the Board no longer would maintain a list of "problem" savings and loan associations. Wall Street Journal, Sept. 24, 1981, at 6. Pratt further predicted that the number of savings and loan mergers in 1982 would increase from an annual average of fifty to more than four hundred. *Id.*

⁹ See S. REP. NO. 97-144, 97th Cong., 1st Sess. 107-110 reprinted in [1981 Supp.] U.S. CODE CONG. & AD. NEWS 191, 295-98; H.R. CONF. REP. NO. 97-215, 97th Cong., 1st Sess. 241-44, 283-85 reprinted in [1981 Supp.] U.S. CODE CONG. & AD. NEWS 371, 415-18, 458-60; see also 127 CONG. REC. H5975-76 (daily ed. Aug. 4, 1981) (remarks by Rep. Rostenkowski).

¹⁰ I.R.C. § 128.

¹¹ I.R.C. § 368(a)(3)(D). This provision reads in pertinent part as follows:

(D) Agency Proceedings which involve financial institutions.

(i) For purpose of subparagraphs (A) and (B)

(I) In the case of a receivership, foreclosure, or similar proceeding before a Federal or State agency involving a financial institution to which section 585 applies, the agency shall be treated as a court, and

(II) In the case of a financial institution to which section 593 applies, the term 'title 11 or similar case' means only a case in which the Board (which will be treated as the court in such case) makes the certification described in clause (ii).

(ii) A transaction otherwise meeting the requirements of subparagraph (G) of paragraph (1), in which the transferor corporation is a financial institution to which section 593 applies, will not be disqualified as a reorganization if no stock or securities of the corporation to which the assets are transferred (transferee) are received or distributed, but only if all of the following conditions are met:

(I) the requirements of subparagraphs (A) and (B) of section 354(b)(1) are met with respect to the acquisition of the assets,

(II) substantially all of the liabilities of the transferor immediately before the transfer become, as a result of the transfer, liabilities of the transferee, and

(III) the Board certifies that the grounds set forth in section 1464(d)(6)(A)(i), (ii), or (iii) of title 12, United States Code, exist with respect to the transferor or will exist in the near future in the absence of action by the Board.

(iii) For purposes of this subparagraph, the 'Board' means the Federal Home

investment dollars to the industry.¹² Recognizing the practicalities of pro-longer financial stress, however, Congress devised the latter provision to salvage the maximum number of dollars possible from drowning institutions, by authorizing their acquisition by financially stronger institutions with minimal tax consequences.¹³

Whether or not the new reorganization provision, section 368(a)(3)(D),¹⁴ succeeds in inducing the acquisition of insolvent savings and loan associations, it is likely to be viewed as a creative attempt at a solution. To best illustrate the novelty of Congress's approach, the ensuing sections begin with an explanation of federal tax law as it has evolved in the context of insolvency reorganizations.

II. THE REORGANIZATION CONCEPT

Insolvency reorganizations under the tax laws have a long and varied history. By 1944, section 112 of the Internal Revenue Code of 1939 contained extensive provisions governing reorganizations in receivership and bankruptcy proceedings.¹⁵ During ensuing sessions Congress enacted a series of provisions to provide tax deferral for corporate and individual taxpayers in similar contexts.¹⁶ To understand the impact of section 368(a)(3)(D) on savings and loan institutions, therefore, a brief discussion of prior law is required.

In general, the Internal Revenue Code (Code) imposes a tax on all gains from the sale or exchange of property, unless otherwise provided.¹⁷ Conversely, certain losses are deductible from gross income.¹⁸ The reorganization provisions provide exceptions to these general rules by authorizing taxpayers to defer recognition of certain gains and losses and, in effect,

Loan Bank Board or the Federal Savings and Loan Insurance Corporation or, if neither has supervisory authority with respect to the transferor, the equivalent State authority.

¹² S. REP. NO. 97-144, 97th Cong., 1st Sess. 107 reprinted in [1981 Supp.] U.S. CODE CONG. & AD. NEWS 191, 295.

¹³ H.R. CONF. REP. NO. 97-215, 97th Cong., 1st Sess. 283, reprinted in [1981 Supp.] U.S. CODE CONG. & AD. NEWS 371, 458.

¹⁴ See *supra* note 11.

¹⁵ Int. Rev. Code of 1939, ch. 1, § 112(b)(10), (c), (d), (e), (k), and (11), 58 Stat. 41 (1944) (current version at I.R.C. § 368 (1976)), amending I.R.C. § 112, 53 Stat. 37 (1939).

¹⁶ I.R.C. §§ 371-74 (1976). For the legislative history of these provisions, see [1954] U.S. CODE CONG. & AD. NEWS 4272, 4913, 5293; [1956] U.S. CODE CONG. & AD. NEWS 2910; [1976] U.S. CODE CONG. & AD. NEWS 2897. For the 1980 amendment, see I.R.C. § 368 (a)(1)(G); see also text accompanying notes 22-30, *infra*.

¹⁷ I.R.C. § 61(a)(3) (gains from dealings in property includable in gross income); I.R.C. § 1001 (difference between amount realized and adjusted basis is amount of gain or loss and gains must be recognized unless otherwise provided).

¹⁸ See I.R.C. § 165(a) (losses sustained during taxable year are deductible if not compensated by insurance or otherwise).

to treat qualified reorganizations as nontaxable events.¹⁹ The Code accords tax-free status to a number of reorganization methods, each of which serves particular corporate and shareholder purposes.²⁰ One such method is the insolvency reorganization, whereby an insolvent corporation undergoing receivership, foreclosure, or bankruptcy proceedings is restructured.²¹

Prior to 1980, most insolvency reorganizations were governed by sections 371 to 374 of the 1954 Code.²² The rules of these provisions applied to transfers of property by an insolvent corporation²³ and to exchanges of stock or securities between creditors or shareholders of the insolvent corporation and another corporation.²⁴ Essentially, section 371 required that the insolvent corporation transfer all or part of its property to a corporation formed or used to carry out a court-approved plan of

¹⁹ The corporate reorganization provisions of the I.R.C. have received considerable attention from the commentators. See generally Freling & Martin, *Current Reorganization Techniques*, 55 TAXES 852 (1977); Stark, *Non-Income Tax Aspects of Corporate Reorganizations: A Check List of the Issues and Problems*, 24 N.Y.U. INST. ON FED. TAX 1085 (1966); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183 (1957).

²⁰ See I.R.C. § 368. The categories of corporate reorganizations recognized by § 368(a) include statutory mergers or consolidations, stock-for-stock exchanges, asset reorganizations, changes in identity, form or place, and insolvency reorganizations. In addition, § 368 recognizes certain "hybrid" reorganizations, which possess characteristics of several different forms. See § 368(a)(2)(D) and (E). See generally B. BITTKER, *FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS* 94.1-94.66 (1981).

The same basic forms of reorganization set forth in § 368(a) accommodate a variety of nontax business objectives. See Darrell, *supra* note 19, at 1183-84. An "A", "B", or "C" reorganization is employed when the reorganization plan contemplates a permanent combination of the operations or assets of two or more corporations. A "B" reorganization is used, for example, when the acquiring corporation seeks to acquire a subsidiary and to preserve the latter as a separate corporate entity. See generally Stark, *supra* note 5.

²¹ For a general discussion of insolvency reorganizations, see Berger, *Acquisitions of Financially Troubled Businesses*, 50 TAXES 809 (1972); Tillinghast & Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act*, 26 TAX L. REV. 663 (1971).

²² I.R.C. §§ 371-74. Section 371(a) contained the principal non-recognition provision and provided in pertinent part as follows:

(1) In general. - No gain or loss shall be recognized if property of a corporation . . . is transferred in pursuance of an order of the court having jurisdiction of such corporation —

(A) in a receivership, foreclosure, or similar proceeding, or

(B) in a proceeding under chapter X of the Bankruptcy Act (11 U.S.C. §§ 501 and following).

to another corporation organized or made use of to effectuate a plan of reorganization approved by the court in such proceeding in exchange solely for stock or securities in such other corporation.

With certain exceptions, this section only applies to insolvency reorganizations commenced prior to October 1, 1979, and has been replaced by provisions set forth in § 368(a)(1)(G). See text accompanying notes 38-48, *infra*.

²³ See Treas. Reg. § 1.371-1 (1960).

²⁴ See I.R.C. § 371(b)(1); Treas. Reg. § 1.371-2 (1960). Under these sections an insolvency reorganization utilizing a stock-for-stock exchange may resemble a reorganization under § 368(a)(1)(B), without the requirement that the exchange be "solely for voting stock." For a discussion of "B" reorganizations, see Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), *cert. denied*, 101 S. Ct. 2351 (1981); Comment, *The "Solely For Voting Stock" Requirement of B Reorganizations: Reeves v. Commissioner*, 79 COLUM. L. REV. 774 (1979).

reorganization in exchange solely for stock or securities of the transferee.²⁵ The transfers of property and of stock or securities had to be pursuant to an order of the court having jurisdiction over the receivership, foreclosure, or similar proceeding,²⁶ pursuant to the plan of reorganization, and germane to the plan.²⁷ No gains or losses were recognized as a result of these transfers if all requirements of the statute were satisfied.²⁸ The basis of property received by the transferee or acquiring corporation was the same as it was in the transferor, increased by any gain recognized to the transferor under law applicable in the year of acquisition.²⁹ The transfer of property in exchange for "boot" did not jeopardize the over-all tax-exempt status of the reorganization, if such exchange was pursuant to the plan of reorganization.³⁰

²⁵ See *supra* note 28; Treas. Reg. § 1.371-1 (1960). The regulations did not define "stock or securities" for purposes of a transfer under § 371, except to state that a "short-term purchase money note" was not a "security". *Id.* §§ 1.371-1(a)(5) and 1.371-2(b). The regulations did provide, however, that creditors of the insolvent corporation would be treated as shareholders for purposes of § 371 if the creditors had effective command over the corporation's assets. *Id.* § 1.371-1(a)(4).

²⁶ See *supra* note 22.

²⁷ *Id.* The regulations also required that each corporation which is a party to a § 371 reorganization provide the Internal Revenue Service with "a complete statement of all facts pertinent to the nonrecognition of gain or loss," including (1) a certified copy of the "plan of reorganization approved by the court"; (2) a statement describing the transaction and its purposes; (3) a complete statement outlining the cost or basis of all property transferred; (4) a statement setting forth the stock, securities, property or money exchanged; (5) a statement describing all distributions or dispositions of property; and (6) the amount and nature of liabilities assumed. *Id.* § 1.371-1(c).

²⁸ See *Id.* § 1.371-1(a)(3). As with other reorganizations, the provisions of § 371(a) have been strictly construed to prevent abuse. Although the nonrecognition provisions of the I.R.C. were enacted to facilitate restructuring of enterprises and other legitimate business adjustments, Congress has long been aware of the potential for tax avoidance. See, e.g., H.R. REP. No. 704, 73d Cong., 2d Sess. 13 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 15 (1934). Although the requirement for court approval under § 371 provided a means to prevent obvious abuses, the regulations cautioned that "the section is inapplicable unless there is a bona fide plan of reorganization approved by the court." Treas. Reg. § 1.371-1(a)(3).

²⁹ I.R.C. § 372(a). For the insolvent corporation or its shareholders or creditors, the basis of new stock or securities received was the same as the stock or securities exchanged or extinguished in the transaction, decreased by (1) the amount of money or other property received and (2) the amount of any recognized loss. In addition, the basis of such property was increased by the amount of any recognized gain. See *Id.* § 372(c); see also *Id.* § 358.

The cancellation of indebtedness pursuant to the plan of reorganization, however, did not result in an adjustment in basis under I.R.C. § 1017. Treas. Reg. § 1.372-1(a). On the other hand, liabilities assumed as part of the plan of reorganization were not treated as "other property" under § 357(a). See *infra* note 30.

³⁰ I.R.C. § 371(a)(2). "Boot" refers to any consideration received by the transferor other than "stock or securities." See also Treas. Reg. § 1.356-1(a) (1960). Under § 371(a)(2), the transferor corporation receiving money or other property recognized no gain if, under the plan, it distributed the boot to shareholders or creditors. Otherwise, the transferor corporation recognized gain up to the amount of undistributed money or, in the case of other property, the fair market value of such property received. I.R.C. § 372(a)(2).

Holders of the transferor's stock or securities recognized a capital gain up to the amount of boot distributed to them. *Id.* § 372(b)(2); Treas. Reg. § 1.371-2(c)(1). Thus, the receipt of money or other consideration by the holders of stock or securities in the insolvent corporation was not taxed as a dividend. Moreover, liabilities assumed by the transferee under the plan were not treated as money or other property pursuant to § 357(a). Therefore,

In addition to the express statutory provisions, insolvency reorganizations under section 371 had to satisfy certain underlying assumptions and purposes of nonrecognition which had been developed by the courts. First, the reorganization had to serve a business purpose, and not merely provide a means for tax avoidance.³¹ Although a legitimate business purpose would be implicit in a court-approved plan, the importance of this requirement could never be ignored.³² Second, there had to be a continuity of the business enterprise.³³ Thus, the nonrecognition accorded by section 371 was not available where the insolvent corporation was undergoing liquidation or otherwise winding up the business.³⁴ Third, an insolvency reorganization was subject to a "continuity of interest" rule, which required a continuing proprietary interest by shareholders or creditors of the transferor corporation.³⁵ This requirement was originally fashioned by the courts to prevent

the assumption of liabilities was not recognized to the transferor corporation, its shareholders or its creditors.

³¹ See Treas. Reg. § 1.371-1(a)(3).

³² The "business purpose doctrine", which applies generally to all reorganizations, developed from the Supreme Court's decision in *Gregory v. Helvering*, 293 U.S. 465 (1935). The regulations accompanying § 368 emphasize that the reorganization provisions concern "readjustments of corporate structures . . . required by business exigencies." Treas. Reg. § 1.368-1(b); see also *Wortham Machine Co. v. United States*, 521 F.2d 160 (10th Cir. 1975) (business purpose required in "C" reorganization); *American Bronze Corp. v. Commissioner*, 64 T.C. 1111 (1975) (business purpose required in merger of affiliated corporations). The business purpose doctrine was a response to taxpayers' maneuvers to remove corporate earnings and profits through corporate divisions and reorganizations. These maneuvers, commonly called "bail outs," allowed the taxpayer to manipulate the tax provisions so as to receive favorable tax treatment. Once the business purpose doctrine is imposed on the transaction, however, the taxpayer must justify the transaction in terms of business exigencies. In applying this doctrine, the courts scrutinize both corporate and shareholder motives. To determine whether the transaction satisfies this somewhat amorphous standard. See, e.g., *Parshelsky's Est. v. Commissioner*, 303 F.2d 14 (2d Cir. 1962); *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949).

³³ Treas. Reg. § 1.371-1(a)(4); see *infra* note 34.

³⁴ See *Standard Realization Co. v. Commissioner*, 10 T.C. 708 (1948). Section 371(a) "applies only to a genuine reorganization as distinguished from a liquidation and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation." Treas. Reg. § 1.371-1(a)(4). The regulations contemplated a continuation of the business in the reorganized form, but did not require continuation in the same line of business. The reorganized entity must continue some business activity, therefore, and not merely serve as a shell pending liquidation or sale. See Rev. Rul. 63-29, 1963-1 Cum. Bull. 77. Thus, a bona fide reorganization can take place even though the transferor's business was terminated and some of its assets were distributed in partial liquidation. *Beecher v. Commissioner*, 221 F.2d 252 (2d Cir. 1955).

³⁵ Treas. Reg. § 1.371-1(a)(4). The courts developed the continuity of interest requirement to distinguish tax-free reorganizations from outright sales. See, e.g., *Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 470 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). As developed by the courts, the continuity of interest doctrine requires both a substantial continuity in proprietary interest and a substantial percentage participation by shareholders of the acquired corporation. See *Commissioner v. Berghash*, 361 F.2d 257, 259-60 (2d Cir. 1966). Thus, continued participation by major shareholders may be insufficient to satisfy the test if many smaller shareholders elect a cash distribution. *Id.* (continuity of interest not satisfied if 50% of shareholders do not participate).

use of the reorganization provisions as a means to "bail out" profits.³⁶ Finally, insolvency reorganizations under section 371 were subject to scrutiny under the step-transaction doctrine with all its attendant intricacies.³⁷

In 1980, Congress enacted a new reorganization provision, replacing sections 371 through 374, setting forth revised requirements, and conforming insolvency reorganizations to the newly enacted Bankruptcy Act.³⁸ Sections 371 through 374 were "terminated" for cases and proceedings commenced after September 30, 1979.³⁹ The new reorganization provisions, found in section 368(a)(1)(G), require a transfer pursuant to a court-approved plan of "substantially all" the assets of the insolvent corporation to an acquiring corporation.⁴⁰ In exchange, the transferee corporation must distribute stock or securities to the owners of the insolvent corporation⁴¹

³⁶ See, e.g., *Letulle v. Scofield*, 308 U.S. 415 (1940); *G & K Mfg. Co. v. Helvering*, 296 U.S. 389 (1935); note 35, *supra*. For a definition of "bail out," see *supra* note 32.

³⁷ See *Treas. Reg. § 1.371-2(a)(2)*. The step-transaction doctrine, a general principle of tax law, is applied to determine which acts constitute part of an integrated transaction and which should not properly be considered part of the event under scrutiny. The doctrine has been applied both to affirm and to deny nonrecognition under the corporate reorganization provisions. In this context, the courts apply the step-transaction doctrine to determine whether necessary transfers or other events have occurred pursuant to the plan of reorganization or apart from it. For example, transactions in excess of twelve months' duration have been held ineligible for qualification in the absence of a continuing offer by the acquiring corporation. See *American Potash & Chemical Corp. v. United States*, 402 F.2d 1000, 1001 (Ct. Cl. 1968); *Lutkins v. United States*, 312 F.2d 803, 804-05 (Ct. Cl. 1962), *cert. denied*, 375 U.S. 825 (1963); see also *Mintz & Plumb, Step-transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX. 247 (1954).

³⁸ See, *Bankruptcy Act of 1980*, Pub. L. No. 96-589, § 4(a), (h)(3), 94 Stat. 3401-03, 3405 (codified as I.R.C. § 368(a)(1)(G)). See also S. REP. No. 96-1035, 96th Cong., 2d Sess. 5, reprinted in [1980] U.S. Code Cong. & Ad. News 7017, 7021 (hereinafter cited as S. Rep. No. 96-1035).

³⁹ I.R.C. § 370. Subsections (c) and (e) of § 374, applying to railroad reorganizations, were not terminated. *Id.* § 370(b). Although § 370(a) states that §§ 371-74 shall not apply to proceedings begun after September 30, 1979, the effective date of termination was not until January 1, 1981. Debtors in proceedings commenced during the period October 1, 1979 through December 31, 1980, can elect to reorganize under § 371 or the new provisions under § 368(a)(1)(G).

⁴⁰ The "G" reorganization provision states in pertinent part as follows:

(G) a transfer by a corporation of all or part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

I.R.C. § 368(a)(1)(G). Section 354 provides that a qualifying reorganization will result in the nonrecognition of gain or loss. See *infra* note 42. Section 368(a)(3)(A) defines "title 11 or similar case" as a case under title 11 of the U.S. Code, or a receivership, foreclosure, or similar proceeding in a federal or state court.

The requirement that "substantially all" assets be transferred is a condition of nonrecognition set forth in § 354(b). The term "substantially all," in the context of a "G" reorganization, does not mean that "all" the available assets must be transferred to the transferee. The legislative history indicates that certain assets may be sold to raise cash, or to pay off creditors, and that a court should look at the underlying intent of the parties to determine if the transaction qualifies. See S. REP. No. 96-1035, *supra* note 38.

⁴¹ I.R.C. § 368(a)(1)(G). In addition, some of the holders of securities in the insolvent corporation must receive stock or securities. However, a shareholder or security holder receiving securities with a principal amount exceeding the principal amount of securities surrendered will be taxed on the excess. See S. REP. No. 96-1035, *supra* note 38, at 5.

in a transaction qualifying under sections 354, 355 or 356.⁴² The new law permits the exchange of money or other property in a "G" reorganization. The receipt of boot by shareholders of the insolvent corporation, however, is subject to a dividend-equivalence test.⁴³

The new law contains some changes from section 371. Unlike prior law, section 368(a)(1)(G) requires a transfer of substantially all assets of the insolvent corporation and requires a distribution of stock or securities to the owners of the insolvent corporation.⁴⁴ Section 368 also expressly provides for "hybrid" reorganizations, an option not available under section 371.⁴⁵

A "G" reorganization, like other reorganizations under section 368 must satisfy the underlying purposes for nonrecognition.⁴⁶ Moreover, a transaction pursuant to section 368(a)(1)(G) must be supported by a business purpose and presumably will be subject to judicial application of the step-transaction doctrine.⁴⁷ The requirement of primary importance, however, is the continuity of interest rule, which demands a continuing proprietary

⁴² I.R.C. § 354(a) is the general nonrecognition statute applying to reorganizations which qualify under § 368(a)(1). Section 354(a) reads in pertinent part as follows:

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

To qualify for nonrecognition, the insolvent corporation in a G reorganization must also transfer substantially all of its assets to a single transferee corporation and distribute all of the stocks or securities received from the transferee, along with remaining assets, to its shareholders and security holders. I.R.C. § 354(b). The distribution requirements of §§ 368(a)(1)(G) and 354(b) ensure a continuing proprietary interest by owners of the insolvent corporation. See *supra* note 35.

Section 355 is similar in function to § 354, but only applies to divisive distributions. Divisive distributions include spin-offs, split-ups, and split-offs, consideration of which is well beyond the scope of this paper. See generally Massee, *Section 355: Disposal of Unwanted Assets in Connection With A Reorganization*, 22 TAX L. REV. 439 (1967) (nonrecognition in simultaneous divisive and unifying reorganizations); Piper, *Combining a Spin-Off With a Merger - Recent Developments*, 49 TAXES 134 (1971) (risks in combining corporate division and merger).

I.R.C. § 355 governs receipt of boot in transactions otherwise qualifying for nonrecognition under §§ 354 or 355. In general, § 356 provides that gain will be recognized in a reorganization. I.R.C. § 356(a)(1). Certain gains from the receipt of money or other property may be treated as dividends and taxed as ordinary income. I.R.C. § 356(a)(2).

⁴³ I.R.C. § 356(a)(2); see S. REP. No. 96-1035, *supra* note 38, at 5. Receipt of boot by shareholders in the form of money or other property will be examined to determine whether the "reorganization" is bona fide or an outright sale of the insolvent business. Similarly, receipt of securities, with a principal amount in excess of securities surrendered, will result in the excess being treated as boot. If security holders in the insolvent corporation do not surrender their securities at all, the entire principal amount will be treated as boot.

⁴⁴ See *supra* note 42.

⁴⁵ The new law permits both triangular and reverse mergers in the context of a "G" reorganization. I.R.C. § 368(a)(2)(C) and (D). Moreover, a "G" reorganization may be followed by a "drop down" of property to the transferee's subsidiary. Thus, the assets acquired by the transferee corporation may be transferred to a subsidiary without the loss of nonrecognition treatment. *Id.*

⁴⁶ See *supra* text accompanying notes 31-37.

⁴⁷ See *supra* text accompanying notes 31-32 and 37.

interest by the owners of the insolvent corporation.⁴⁸ For savings and loan associations this requirement takes on special significance, since it is conspicuously absent from the insolvency reorganization provision Congress added for financially troubled savings and loan associations in the Economic Recovery Act of 1981.⁴⁹

III. SECTION 368(a)(3)(D): SPECIAL ASSISTANCE FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

Having refurbished the insolvency reorganization provisions in 1980 by the addition of "G" reorganizations,⁵⁰ Congress on August 13, 1981, passed the Economic Recovery Act of 1981.⁵¹ Included in this statute is section 368(a)(3)(D), which amends the reorganization provisions to allow tax-free treatment for the reorganization of certain financially troubled thrift institutions.⁵² Despite the complexity of its statutory requirements, this new provision offers a degree of flexibility which is unprecedented in reorganization law. Its most startling feature, however, is the abandonment of a formal continuity of interest requirement⁵³ for qualifying transactions.⁵⁴

Under the new law the transferor must be an institution to which Code section 593 applies.⁵⁵ The eligible institutions are mutual savings banks, certain cooperative banks operated as mutual associations, and building and loan associations.⁵⁶ State and federally chartered savings and loan associations qualify as building and loan associations by virtue of the latter's expansive definition in Code section 7701(a)(19).⁵⁷

To qualify for tax-free treatment under section 368(a)(3)(D), the transaction must meet four conditions. The first condition is that the transaction qualify as a "G" reorganization,⁵⁸ except that the savings and loan association need not receive or distribute the stock or securities of the transferee.⁵⁹ This exception, which sets thrift institution reorganizations apart from other reorganizations, is a relinquishment of the continuity of in-

⁴⁸ See *supra* note 35. Unlike an asset transfer under § 368(a)(1)(D), however, there is no requirement that shareholders maintain control of the reorganized corporation.

⁴⁹ Pub. L. 97-34, 95 Stat. 172 (1981).

⁵⁰ See *supra* notes 38-47 and accompanying text.

⁵¹ See *supra* note 49.

⁵² See *supra* note 11.

⁵³ See *supra* notes 35 and 48 and accompanying text.

⁵⁴ For discussion of such transactions see *infra* notes 55 to 71 and accompanying text.

⁵⁵ I.R.C. § 368(a)(D)(i)(II); see *supra* note 11. Section 593 states in pertinent part as follows:

(a) Organizations to which section applies. — This section shall apply to any mutual savings bank, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes and without profit.

⁵⁶ See *supra* note 55.

⁵⁷ I.R.C. § 7701(a)(19).

⁵⁸ See *supra* text accompanying notes 38-48.

⁵⁹ I.R.C. § 368(a)(3)(D)(ii); see *supra* note 11.

terest requirement.⁶⁰ Within the context of other reorganizations the rule exists to prevent the "bail out" of assets.⁶¹ This objective is accomplished by requiring that the owners of the transferor maintain a continuing proprietary interest immediately following the reorganization.⁶² This requirement appears unnecessary in section 368(a)(3)(D) transactions, since qualifying financially troubled institutions will not contain the amount of assets or profits which are conducive to a "bail out." Moreover, the possibility exists that Congress intended to make section 368(a)(3)(D) transactions more attractive by not requiring that the transferee dilute the value of its stock or deplete its capital reserves in order to meet the continuity of interest doctrine.

The second condition a transaction must meet in order to qualify under section 368(a)(3)(D) is that it comply with Code section 354(b)(1).⁶³ This section requires that the transferee acquire "substantially all"⁶⁴ of the transferor's assets. Moreover, any remaining property of the transferor, including any stock, securities or other property received by the transferor, must be distributed pursuant to the plan of reorganization.

The third condition for qualification under section 368(a)(3)(D) is that the transferee assume "substantially all" of the transferor's liabilities as they existed "immediately before the transfer."⁶⁵ This condition was not included in the requirements for a "G" reorganization.⁶⁶ To facilitate the reorganization of a savings and loan association, however, the assumption of liabilities provision is crucial, since a significant portion of the association's liabilities are likely to be customer deposits.

The final condition expressed in section 368(a)(3)(D) is that the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, or the "equivalent state authority"⁶⁷ certify that the savings and loan association is or is about to be in one of three circumstances.⁶⁸ The first possible circumstance is that the association is insolvent in that

⁶⁰ For a discussion of the "continuity of interest" doctrine, see *supra* text accompanying note 32.

⁶¹ For a discussion of the "bail out" principle, see *supra* text accompanying note 32.

⁶² See *supra* text accompanying notes 35 to 36.

⁶³ I.R.C. § 368(a)(3)(D)(ii)(I); see *supra* note 11.

⁶⁴ I.R.C. § 354(b)(1)(A). In the context of tax-free reorganization, the term "substantially all" appears to assume its plain meaning and turns on the facts of each case. See B. Bittker, *supra* note 20, at 94.3.4; see also *supra* note 40.

⁶⁵ I.R.C. § 368(a)(ii)(II); see *supra* notes 11 and 64.

⁶⁶ See *supra* text accompanying notes 38-48.

⁶⁷ I.R.C. § 368(a)(3)(D)(iii); see *supra* note 11.

⁶⁸ I.R.C. § 368(a)(3)(D)(ii)(III); see *supra* note 11.

its obligations exceed its assets.⁶⁹ The second possibility is that the association's assets are substantially dissipated because of unsafe or unsound practices or because of violations of law.⁷⁰ The third possibility is that the association is in "an unsafe or unsound condition to transact business."⁷¹

The requirements of the new provision for financially troubled thrift institutions may appear somewhat complex. In fact, an insolvent institution qualifying under section 593 can still undergo a more traditional "G" reorganization, if the case is certified by the appropriate agency.⁷² However, the special provisions of section 368(a)(3)(D) appear far more likely than the available alternatives to induce the beneficial business adjustments desired by Congress, because of the absence of a formal continuity of interest requirement and the relative flexibility of the new law. Section 368(a)(3)(D) is not a panacea for the many problems which confront the thrift industry. It does provide, however, a valuable new tool for the strengthening and restructuring of an industry in transition.

⁶⁹ 12 U.S.C. § 1464(d)(6)(A) (1976) states in pertinent part as follows:

The grounds for the appointment of a conservator or receiver for an association shall be one or more of the following: (i) insolvency in that the assets of the association are less than its obligations to its creditors and others, including its members; (ii) substantial dissipation of assets or earnings due to any violation or violations of law, rules, or regulations, or to any unsafe or unsound practice or practices; (iii) an unsafe or unsound condition to transact business.

⁷⁰ *Id.*

⁷¹ *Id.* The legislative history also indicates a further limitation on certification by the Board. See H.R. CONF. REP. No. 97-215, 97th Cong., 1st Sess. reprinted in [1981 Supp.] U.S. CODE CONG. & AD. NEWS 371. The conferees clearly stated their intention that I.R.C. § 269 provides in pertinent part that in the case of a corporate acquisition, when "the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit or other allowance . . . (the taxpayer) would not otherwise enjoy, then the Secretary may disallow such deduction, credit or other allowance." *Id.* § 269(a) (emphasis added). Apparently construing this section in the context of a savings and loan association reorganization, the conferees state their intention that there be no certification where the association purposely has placed itself in one of the circumstances necessary for certification. See *supra* note 69. Moreover, the conferees stated their intention that the Board make no certification under 12 U.S.C. § 1464(d)(6)(A)(ii) or (iii) unless the association is unable or in the near future will be unable to meet its obligations as they come due. *Id.*

⁷² See I.R.C. § 368(a)(3)(D)(i)(II); see *supra* note 11. Thus, a reorganization which meets all of the requirements of § 368(a)(1)(G) still must be certified as insolvent or otherwise eligible for a tax-free reorganization by the appropriate agency pursuant to the grounds set forth in 12 U.S.C. § 1464(d)(6)(A)(i), (ii), or (iii). See *supra* text accompanying note 58-71.

