

Louisiana Law Review

Volume 2 | Number 2

January 1940

Tax-Free Corporate Exchanges in the Louisiana Income Tax Law

M. G. Dakin

Repository Citation

M. G. Dakin, *Tax-Free Corporate Exchanges in the Louisiana Income Tax Law*, 2 La. L. Rev. (1940)

Available at: <https://digitalcommons.law.lsu.edu/lalrev/vol2/iss2/3>

This Article is brought to you for free and open access by the Law Reviews and Journals at LSU Law Digital Commons. It has been accepted for inclusion in Louisiana Law Review by an authorized editor of LSU Law Digital Commons. For more information, please contact kreed25@lsu.edu.

Tax-Free Corporate Exchanges in the Louisiana Income Tax Law

M. G. DAKIN*

In 1934, spurred by the need for additional revenue, the Louisiana legislature added an income tax law¹ to the State tax structure. As had been the case in other states,² the federal income tax acts were leaned upon heavily by the Louisiana draftsmen. In substantial portions of the taxing act, however, they not only used the federal statutes as a model but copied numerous sections verbatim. As a result of this procedure, the Louisiana statute contains all of the intricate and litigious sections of the federal statute devoted to the non-recognition of gains or losses in connection with exchanges of corporate stock and assets. In view of this fact the history of these sections in the federal statute is relevant and instructive. Imbedded in this history lie fundamental limitations which have dictated the language of the statutes.

I. DEVELOPMENT OF THE DOCTRINE OF "REALIZATION"

A review of certain early decisions of the United States Supreme Court is fundamental to an understanding of the sections dealing with recognition of capital gains and losses. In these cases the Court worked out the limitations of the term *income* as it is used in the Sixteenth Amendment.³

Although income taxes of a minor nature had been accepted as within the taxing power of the United States since the War between the States,⁴ the Supreme Court, in *Pollock v. Farmers*

* Assistant Professor of Business Administration, Louisiana State University.

1. La. Act 21 of 1934, as amended by La. Acts 2 of 1934 (1 E.S.), 7 of 1934 (2 E.S.), 21 of 1935 (1 E.S.), 11 of 1935 (3 E.S.), and 26 and 143 of 1936. [Dart's Stats. (1939) § 8587.1 et seq.]. For a discussion of jurisdictional and retroactive aspects of the Act see Weinmann, *The Louisiana Income Tax Law* (1935) 9 *Tulane L. Rev.* 566. No parts of the Act have yet been interpreted by the Louisiana Supreme Court.

2. Okla. Sess. Laws (1935) c. 66.

3. U.S. Const. Amend. XVI.

4. *Stockdale v. Insurance Companies*, 87 U.S. 323, 22 L.Ed. 348 (1873). Cf. *Springer v. United States*, 102 U.S. 586, 26 L.Ed. 253 (1880), in which the Supreme Court held that an income tax is an indirect tax and that direct taxes, within the Constitution, are capitation taxes and taxes on real estate. See Powell, *Stock Dividends, Direct Taxes, and the Sixteenth Amendment* (1920) 20 *Col. L. Rev.* 536, 537.

Loan & Trust Co.,⁵ found a fatal flaw in this long accepted revenue device. The Supreme Court in that case established over vigorous dissents that a tax on the income from property, though theretofore unchallenged, was a direct tax on property and hence subject to the constitutional requirement of apportionment.⁶ The decision met with subsequent widespread disapproval. This public disfavor prompted the adoption of the Sixteenth Amendment in 1913. The amendment has been aptly referred to as a recall of the *Pollock* decision.⁷ Those who framed the amendment to the fundamental law, however, concerned as they were with the immediate problem at hand, failed to use language as broad in its terms as the implications of the *Pollock* decision.⁸ As a result, the amendment exempted taxes on income from the rule of apportionment⁹ but left intact the prohibition of other direct taxes, such as those on capital value.¹⁰ The effect was to raise as a constitutional issue¹¹ the litigious question of the distinction between capital and income. Out of this history important concepts developed, one of which concerned the constitutionality of an income tax which operated retroactively to cover the period before legislative enactment. The Court conceived of income as a flow of wealth to which the taxpayer had had no previous claim;¹² hence profits accrued prior to the amendment but collected afterwards could not be brought within this concept of income.¹³ The federal judiciary was consequently forced into the artificial position that such profits were converted into capital at that date, and any tax upon them would be a capital levy and invalid unless apportioned.¹⁴

5. 157 U.S. 429, 15 S.Ct. 673, 39 L.Ed. 759 (1895).

6. 157 U.S. at 583, 15 S.Ct. at 690, 39 L.Ed. at 820.

7. Powell, op. cit. supra note 4, at 533.

8. The Sixteenth Amendment freed income taxes of the requirement of apportionment; they still remained direct taxes under the decision in the *Pollock* case. See Amberg, *Retroactive Excise Taxation* (1924) 37 Harv. L. Rev. 691, 695.

9. U.S. Const. Amend. XVI: "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

10. *Pollock v. Farmers Loan and Trust Co.*, 157 U.S. 429, 15 S.Ct. 673, 39 L.Ed. 759 (1895).

11. *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

12. "Income may be defined as the gain derived from capital, from labor, or from both combined," provided it be understood to include profit gained through a sale or conversion of capital assets . . ." Justice Pitney in *Eisner v. Macomber*, 252 U.S. 189, 207, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

13. *Lynch v. Turrish*, 247 U.S. 221, 38 S.Ct. 537, 62 L.Ed. 1087 (1911); *Merchants Loan and Trust Co. v. Smietanka*, 255 U.S. 509, 41 S.Ct. 386, 65 L.Ed. 751 (1921).

14. The limitations upon this position are discussed infra, p. 215. See Rottschaeffer, *The Minnesota State Income Tax* (1934) 18 Minn. L. Rev. 93, 124.

Corporate stockholders immediately relied upon this principle as a basis for claiming exemption from tax for dividends paid out of profits accumulated prior to March 1, 1913. Logically, this portion of a dividend came within the protection of the *Pollock* case as a claim converted into capital before the effective date of the Sixteenth Amendment. The Court, however, in the case of *Lynch v. Hornby*¹⁵ evolved the argument that income, as conceived in the Revenue Act of 1913, was an individual concept which did not embrace the profits accruing to a corporation until they were actually paid to the stockholder in the form of dividends; thus only upon severance from the corporation did they form a part of the stockholder's annual income. Two years later, in the case of *Eisner v. Macomber*,¹⁶ when the Court was asked to pass upon the taxability of stock dividends, it is evident that the effects of this decision could hardly be avoided. In the *Hornby* case severance of income from capital was regarded as the event upon which taxability would turn and there had thus been made available for taxation a large amount of apparently exempt income. The Court could hardly now upset this decision to save stock dividends, in which there was clearly no severance, even though they might indicate a net economic gain to the taxpayer. In the *Macomber* case much emphasis was placed on the language of the amendment to the effect that the tax is on "incomes from whatever source derived."¹⁷ The Court found it impossible to bring within this concept the receipt of stock certificates which evidenced merely that the profits of the corporation had been reinvested for the stockholder and which gave him nothing out of the assets for his own use and benefit. The Court treated as of no consequence the fact that the stockholder had something which he could sell and which could very well measure a real increase in economic wealth, although dissenting Justice Brandeis¹⁸ argued this vigorously.

In the cases of *United States v. Phellis*¹⁹ and *Rockefeller v. United States*²⁰ which followed later, the Court further refined this idea of severance of income from capital as the criterion of whether the income was within the amendment. In those cases a part of the corporation's assets were transferred to new corporate entities and the stock distributed to the stockholders of

15. 247 U.S. 339, 38 S.Ct. 543, 62 L.Ed. 1149 (1918).

16. 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

17. U.S. Const. Amend. XVI.

18. *Eisner v. Macomber*, 252 U.S. 189, 226, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

19. 257 U.S. 156, 42 S.Ct. 63, 66 L.Ed. 180 (1921).

20. 257 U.S. 176, 42 S.Ct. 68, 66 L.Ed. 186 (1921).

the old corporations. The assets transferred represented accumulations out of profits. It was argued that here, as in the *Macomber* case,²¹ there was no severance, since the stockholders received only certificates evidencing a somewhat changed form of their investment. The Court held, however, that the creation of new corporate entities represented by the new stock and the new property rights and interests said to accompany them, was a change which constituted a severance from the original capital and hence rendered the gain taxable.²² In the subsequent case of *Weiss v. Stearn*²³ an existing corporation was dissolved after transferring its assets to a new corporation for stock and cash, which was in turn distributed to the old stockholders. It was there held that, as to the stock received, no gain or loss would be recognized, presumably because there had been no severance and the stockholder had nothing different from what he theretofore owned.²⁴

The decision in *Marr v. United States*²⁵ followed the next year. In that case stock in an old corporation was exchanged for stock in a new concern organized in another state. The assets of the old corporation were transferred, and the company was dissolved. The gain on the exchange was held taxable on the ground that the amount of new stock received in excess of the old capitalization was a distribution of income earned by the old corporation. A point was also made of the fact that the new corporation was organized in a different state with essential differences in stockholders' rights and interests. These factors, in the eyes of the Court, warranted the conclusion that the stockholders had received something differing in substance from what they previously had; hence that there had been a severance from the original capital.

To the practitioner, whose recompense depended upon correctly forecasting the non-taxability of an exchange, the task of so engineering the exchange as to avoid the recognition of gain was thus fraught with unmarked pitfalls. Several years before these unsettling decisions were handed down, however, Congress had already become cognizant of the dissatisfaction with the uncertain status of reorganizations for taxation purposes, and in

21. *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

22. *United States v. Phellis*, 257 U.S. 156, 173, 42 S.Ct. 63, 66 L.Ed. 180 (1921).

23. 265 U.S. 242, 44 S.Ct. 490, 68 L.Ed. 1001 (1924).

24. *Eisner v. Macomber*, 257 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

25. 268 U.S. 536, 45 S.Ct. 575, 69 L.Ed. 1079 (1925).

the Act of 1918 they were for the first time specifically listed as tax-free exchanges.

II. DEVELOPMENT OF THE STATUTORY PROVISIONS

To justify the non-recognition of gain, federal legislators argued that legitimate and needed adjustments in business were being held up as a result of the threat of high surtaxes which would fall upon what were termed merely paper profits. The 1918 Act, therefore, carried the first provision for the non-recognition of gain on stock received on reorganization.²⁶ The practice of recognizing as taxable ordinary exchanges involving the receipt of property which had a market value, however, was continued. The exemption was limited to an exchange where the new stock had the same aggregate par value as the stock for which it had been exchanged. Any excess of par value in stock received was regarded as taxable.²⁷ This was the forerunner of what is now Subsection 29(b)(3)²⁸ in the Louisiana Act.

This provision was continued in the Federal Act of 1921, but with the par value test eliminated.²⁹ As the provision was worded in the 1921 Act³⁰ the exemption applied to securities received in reorganization *by a person*, in place of securities owned *by him*. This was believed to exclude corporations, although the Treasury

26. 40 Stat. 1060, § 202(b) (1918): ". . . But when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

"When . . . the aggregate par or face value of the new stock or securities received is in excess of the aggregate par or face value of the stock or securities exchanged . . . the amount of the excess in par or face value shall be treated as a gain to the extent that the fair market value of the new stock or securities is greater than the cost . . . of the stock or securities exchanged."

27. *Ibid.*

28. La. Act 21 of 1934 [Dart's Stats. (1939) § 8587.1 et seq.].

29. In connection with the general rule recognizing exchanges as taxable, to which the instant provision constitutes an exception, a further limitation was evolved to the effect that exchanges in general would be taxable only if the property had a "readily realizable market value." (42 Stat. 230, § 202(c) (1921). Previously the test had been simply "market value." U.S. Treas. Reg. 45, Art. 1563. That this limitation proved troublesome is evidenced by the fact that it was eliminated in 1924 and the general rule enunciated that all exchanges in which property having a fair market value was received were taxable except those specifically excluded: 43 Stat. 256, § 203(a) (1924), 26 U.S.C.A. § 112(a) (1938). This was the status of exchanges in 1934 when Louisiana enacted the provision.

30. 42 Stat. 230, § 202(c) (2) (1921): "When in the reorganization of one or more corporations a person receives in place of any stock or securities owned *by him*, stock or securities in a corporation a party to or resulting from such reorganization." (Italics supplied.)

Department did not so construe it.³¹ To avoid any difficulty on this score, the 1924 provision was so drawn as clearly to include exchanges by corporations as well as by individuals.³² This was its phrasing as enacted by the legislature of Louisiana in 1934.³³

Another type of exchange, common in reorganization proceedings, was not covered by the wording of the 1921 provision, namely, exchanges of corporate assets other than stock and securities for stock and securities. Only exchanges of stock and securities for other stock and securities were provided for.³⁴ To remedy this situation there was added to the existing "nonrecognition" exchanges what is now Subsection 112(b) (4) in the Federal Act of 1932 and 29(b) (4) in the Louisiana Act.³⁵

The subsection of the federal statute from which Subsection 29(b) (5) of the Louisiana Act was copied was first incorporated into the Revenue Act of 1921.³⁶ The section made provision for those cases where property was transferred to a corporation for stock and thereafter the transferors were in control of such corporation. The subsection may embrace transfers of stock for stock which do not fall within Subsection 29(b) (2) nor are technically transfers in reorganization under Subsection 29(b) (3) and 29(b) (4). Here again the purpose of Congress was to exempt transactions which constituted a change in form only (from direct holding of property by individuals to indirect holding through the corporate device). Much protest was elicited by the 1918 ruling which regarded a transfer of property to a corporation as a closed transaction and taxed it as such.³⁷ The 1921 Act consequently included the provision exempting such transfers. It was so drawn, however, that a transfer of property to a corporation, even for cash, was exempt if immediately thereafter the transferors were

31. U.S. Treas. Reg. 62, Art. 1566(b).

32. 43 Stat. 256, § 203(b) (2) (1924), 26 U.S.C.A. § 112 (1938): "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."

33. La. Act 21 of 1934, § 29(b) (3) [Dart's Stats. (1939) § 8587.29], copied from 47 Stat. 196, § 112(b) (3) (1932).

34. *Supra*, note 30.

35. If property transferred by a corporation is stocks or securities, it is of course covered by both Section 29(b) (3) and (4) provided the corporation is a party to a reorganization. See 2 Paul and Mertens, *The Law of Federal Income Taxation* (1934) 152, § 17.60.

36. 42 Stat. 230, § 202(c) (3) (1921).

37. U.S. Treas. Reg. 45, Art. 1566: "Where property is transferred to a corporation in exchange for its stock, the exchange constitutes a closed transaction. . . ."

in control.³⁸ This gave rise to the amended form in 1924 which exempted only transfers in exchange for stock and securities.³⁹ This was its form when enacted in Louisiana.⁴⁰

The provision for nonrecognition of gain on simple exchanges of stock for stock in the same corporation had a similarly interesting federal history. This provision is now contained in Subsection 29(b)(2) of the Louisiana Act.⁴¹ In the 1921 Act exchanges of property held for productive use or investment for property of like kind were rendered tax free.⁴² As a result, there was a rush to convert stock and securities, which had advanced in value, into other stock and securities, since this could now be accomplished without danger of the gain being taxed.⁴³ To stem this tide of tax-free conversions, Congress hastily amended the section to exclude exchanges of all types of corporate stocks and securities.⁴⁴ Such exchanges, in connection with reorganizations, were already provided for elsewhere.⁴⁵ By the time provisions for the 1924 Act were being drawn, however, a reaction to the amendment was in evidence since it now excluded stock "splits" and the "cutting of melons" even within the same corporation. Subsection 29(b)(2)⁴⁶ was the compromise outcome, providing as it does for exchanges of common stock for common stock, or preferred stock for preferred stock in the same corporation. On principle, this type of exchange could not be distinguished in its effects from the declaration of a stock dividend and, as in the case of stock dividends, lack of severance from the capital of any gain enjoyed would be decisive for nonrecognition in a court test.⁴⁷

38. 42 Stat. 230, § 202(c) (3) (1921): "[No gain or loss shall be recognized] When (A) a person transfers any property, real, personal or mixed, to a corporation, and immediately after the transfer is in control of such corporation. . . ."

39. 43 Stat. 256, § (b) (4) (1924), 26 U.S.C.A. § 112 (1938): "No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation. . . ."

40. La. Act 21 of 1934, § 29(b) (5) [Dart's Stats. (1939) § 8587.29], copied from 47 Stat. 196, § 112(b) (5) (1932).

41. Copied from federal act, 47 Stat. 196, § 112(b) (2) (1932).

42. 42 Stat. 230, § 202(c) (1) (1921).

43. House Ways and Means Comm. Rep. No. 1432, 67th Cong., 3rd and 4th Sess. (1923) 1.

44. 42 Stat. 1560, c. 294 (1921).

45. 42 Stat. 230, § 202(c) (2) (1921).

46. La. Act 21 of 1934 [Dart's Stats. (1939) § 8587.1 et seq.], copied from 47 Stat. 196, § 112(b) (2) (1932), formerly 43 Stat. 256, § 203(b) (1) (1924), 26 U.S.C.A. § 112 (1938).

47. *Eisner v. Macomber*, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920).

III. DEVELOPMENT OF THE DEFINITIONS OF REORGANIZATION AND ASSOCIATED TERMS

A separate subsection devoted to the definition of terms was first included in the Federal Act of 1924.⁴⁸ The meaning there assigned to "reorganization," as used in the statute, remained unchanged through the Act of 1932⁴⁹ when Subsection 29(g) (1) in the Louisiana Act was copied therefrom. As set out in 1924 the provision read:

"Sec. 203 (h) (1) . . . The term reorganization means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation), (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets have been transferred, (C) a recapitalization, (D) a mere change in identity, form, or place of organization, however effected."

Parts (A) and (B) of the definition merit treatment at some length because of the controversy over what they were intended to include. In copying this provision from the Federal Act of 1932 the Louisiana draftsmen, either by accident or intention, omitted the parenthetical illustrations which are set out in Part (A).⁵⁰ They were included only in the Louisiana Rules and Regulations.⁵¹ The status of the illustrations as law is therefore subject to serious question.

Reserving for a time all consideration of the legal status of this subdivision in Louisiana, an examination of federal interpretations of the subdivision will indicate its troublesome character. The difficulty in applying it stemmed from a desire on the part of the Board of Tax Appeals and the courts not to nullify the subdivision which immediately followed it.⁵² Part (B) included as a reorganization a transfer by a corporation of all or a part

48. 43 Stat. 257, § 203(h) (1924), 26 U.S.C.A. § 112 (1938). Section 203(h) (1) (A) of this definition was included in the subsection providing for non-recognition of gain in the case of reorganizations in the 1921 Act. 42 Stat. 230 (1921).

49. 47 Stat. 198, § 112(i)(1) (1932).

50. La. Act 21 of 1934, § 29(g)(1) [Dart's Stats. (1939) § 8587.29].

51. La. Rules and Regulations concerning Income Taxes (1938) arts. 181, 178.

52. *Minnesota Tea Company*, 28 B.T.A. 591, 594 (1933).

of its assets to another corporation if immediately after the transfer the transferor or its stockholders, or both, were in control of the corporation to which the assets were transferred. If the two illustrations included parenthetically in (A) are regarded as constituting statutory types of mergers or consolidations without regard to generally accepted definitions thereof, it is apparent that acquisition of substantially all the assets of a corporation without control will constitute a reorganization under (A) whereas (B) requires that such a transfer be accompanied by 80 per centum control to qualify as a reorganization.

The theory was evolved by the courts that, since Congress could not have intended this result, the parenthetical illustrations could not be construed as reorganizations by themselves, but must also partake of the nature of a merger or consolidation in the accepted sense.⁵³ In other words, Part (A) must be dealt with in its entirety. The parenthetical illustrations could not be viewed apart from the words "merger or consolidation."⁵⁴

Although the view of the courts seems the most reasonable one which could be taken, and retain meaning for Part (B), its actual application has proven extremely difficult. In the *Pinellas Ice Company* case,⁵⁵ where the language of Part (A) was first called in question, there was an attempt to qualify an outright sale of corporate assets for cash and notes, as a reorganization under Part (A) on the ground that it was "an acquisition by one corporation of substantially all the assets of another corporation." The Supreme Court ruled the transaction a simple purchase and sale and hence outside the category of a reorganization. By way of dictum, however, the court threw out the cautioning words⁵⁶ that the statutory definition of "merger or consolidation" contains some things which are beyond the commonly accepted meaning of those words although partaking of the nature of a merger or consolidation. It was this dictum which was applied and developed by the Board of Tax Appeals when a case⁵⁷ arose involving a real clash between Parts (A) and (B). The *Minnesota Tea Company* case involved a transfer of corporate assets for stock and a large amount of cash, neither of which was distributed to the stockholders of the transferor, nor was this latter

53. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 53 S.Ct. 257, 77 L.Ed. 428 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F. (2d) 937 (C.C.A. 2nd, 1932); *Minnesota Tea Company*, 28 B.T.A. 591 (1933).

54. *Minnesota Tea Company*, 28 B.T.A. 591, 594 (1933).

55. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 53 S.Ct. 257, 77 L.Ed. 428 (1933).

56. 287 U.S. at 470, 53 S.Ct. at 260, 77 L.Ed. at 433.

57. *Minnesota Tea Company*, 28 B.T.A. 591 (1933).

corporation dissolved. The Board was unable to find a semblance of merger or consolidation in the transfer and ruled that it did not fall within Part (A). It did not indicate clearly what factors were lacking except to suggest that had there been a distribution of the stock and cash and dissolution of the transferor corporation, Part (A) might have been invoked on the ground that it was in effect a merger.⁵⁸ A true merger, it was noted, necessarily involves new shares to the stockholders representing properties in which theretofore they had no interest. Clearly this factor was lacking here, since the shares were not distributed to the stockholders. Apparently either distribution of new stock by the transferor or distribution and dissolution of the transferor corporation are necessary to give the transaction a semblance of merger or consolidation.⁵⁹ In a companion case⁶⁰ a corporation acquired a majority of all the stock of another corporation in return for stock, and both corporations continued their existence with no dissolution of the old corporation contemplated. Here also the Board held that the transfer did not partake of the nature of a merger or consolidation and Part (A) could not be invoked.⁶¹

Unfortunately the draftsmen of the Louisiana Act copied this definitive subsection before it was clarified in the Act of 1934. However, they did not include the troublesome parenthetical illustrations in their copy.⁶² As noted above, these were added only in the regulations,⁶³ and their appearance even here is perhaps a result of inadvertence in copying the article from Federal Regulations. The State authorities, therefore, could avoid the federal confusion by deleting the illustrations from the Regulations, leaving as Part (A) simply the words "merger or consolidation." These terms could then be given their generally accepted meaning which would normally entail no conflict with Part (B). Even if the illustrations are allowed to remain in the Regulations, their authority is doubtful since they entail an expansion of the terms beyond their commonplace meaning. This the law makers would be presumed not to intend.⁶⁴

Congress attempted a solution by amending the definition in the 1934 Act to read:⁶⁵ "the term reorganization means (A) a

58. 28 B.T.A. at 596.

59. *Ibid.*

60. John J. Watts, 28 B.T.A. 1056 (1933).

61. 28 B.T.A. at 1065.

62. La. Act 21 of 1934, § 29(g)(1) [Dart's Stats. (1939) § 8587.29].

63. La. Rules and Regulations concerning Income Taxes (1938) arts. 181, 178.

64. *Bishop v. State*, 149 Ind. 223, 230, 48 N.E. 1038, 1042 (1898).

65. 48 Stat. 705, § 112(g)(1) (1934), 26 U.S.C.A. § 112 (Supp. 1938).

*statutory*⁶⁶ merger or consolidation or, (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation." The remainder of the definition was retained unchanged except for the change in subdivision lettering.

If a transfer now comes within the language of the new subdivision (B) it will constitute a reorganization, regardless of whether it partakes of the nature of a merger or consolidation. The amendment does more than merely remove the parenthesis and give the illustrations a separate subdivision letter. The property exchanged by the acquiring corporation must now be voting stock. Furthermore, if the acquisition is stock, it must consist of 80 per centum of the voting stock and 80 per centum of all other classes of stock. Previously, in the 1932 Act, there was no stipulation that the acquiring corporation must part with any stock; the *acquisition* of a majority of the voting stock and a majority of the total number of shares of all other classes of stock was all that was required. Consequently, had not the limitation as worked out by the Board⁶⁷ been applied, paragraph (A) would clearly have nullified the requirement in (B) of the 1932 Act that there must be 80 per centum control after the transfer of assets to another corporation. As a result of the amendments the new (B) is limited to acquisition of stock by a corporation in exchange for its own voting stock. The new (C) [1932 (B) unchanged] as previously, defines a transfer of any corporate property to another corporation, as a reorganization so long as immediately thereafter there is the requisite control. The new (B) is obviously necessary since a corporation's own voting stock, even though held as treasury stock, can not rightly be deemed a corporate asset and consequently such an exchange would not be included in the new (C).

The remainder of the definitive subsection⁶⁸ has been retained

66. The injection into (A) of the term *statutory* raises new problems, since a reorganization under this definition may be effected by a corporate rearrangement satisfying the requisites of the state of incorporation. The federal authorities must consequently be in a position to pass upon the merits of any such rearrangement which is alleged to meet the statutory requisites of a state or territory. Where the state of incorporation lays down no statutory rule as to the steps necessary to consummate a merger or consolidation, resort must still be had to general judicial definitions of the term. See 2 Paul and Mertens, op. cit. supra note 35, at 183, § 17.72.

67. Minnesota Tea Company, 28 B.T.A 591 (1933).

68. La. Act 21 of 1934, § 29(g)(1) [Dart's Stats. (1939) § 8587.29].

unchanged in federal acts subsequent to the Act of 1932. The subsection contains two additional types of transactions which will constitute reorganizations. "Recapitalizations," listed as Part (C), was probably inserted in the federal act to cover rearrangements of stock and security rights within the same corporation. Thus the term would cover exchange of common stock for preferred stock and the exchange of par value stock for no-par value stock.⁶⁹ Likewise reduction of corporate capitalization by surrender of a portion of stock for cancellation by shareholders who received no remuneration therefor, would be included here.⁷⁰ The exchange of stocks for bonds has been held to constitute a recapitalization.⁷¹ But the exchange of old bonds for new in a refinancing transaction is not within the purview of this term on the ground that this constitutes a closed transaction.⁷²

Under Subdivision (D) of Subsection 29(g) (1)⁷³ is inserted the catchall phrase "a mere change in indentify, form, or place of organization, however effected." Under the federal act, this part of the reorganization definition has not received very extensive interpretation, due largely perhaps to the fact that most reorganizations can be brought within one of the more limited categories.⁷⁴ However, a Circuit Court of Appeals has held that exchange of all the stock of a corporation in return for all the stock of a newly organized corporation, where the assets of the old corporation were then transferred to the new corporation and the old one dissolved, constitutes a mere change in identity.⁷⁵ Exchange of voting trust certificates for free stock in the same corporation would likewise constitute a mere change in form.⁷⁶ Reincorporation in a new state, where such reincorporation and exchange of stock did not too materially affect shareholders' rights, would probably also constitute a mere change in place of reorganization and constitute a tax-free reorganization.⁷⁷

Only a part of the federal definition of "a party to a reorganization" was taken over by the Louisiana draftsmen in the second paragraph of the subsection⁷⁸ defining a reorganization. This part

69. H. E. Muchnic, Adm'r, 29 B.T.A. 163 (1933).

70. Benjamin W. Fredericks, 21 B.T.A. 433 (1930), affirmed under the title of *Kistler v. Burnet*, 58 F.(2d) 687 (C.C.A. D.C. 1932).

71. Lelia S. Kirby, 35 B.T.A. 578 (1937).

72. I. T. 2035, III-1 Cum. Bull. 55 (1924).

73. La. Act 21 of 1934, § 29(g)(1) [*Dart's Stats.* (1939) § 8587.29].

74. 2 Paul and Mertens, *op. cit. supra* note 35, at 209, § 17.82.

75. *Ahles Realty Corp. v. Commissioner*, 71 F.(2d) 150 (C.C.A. 2nd, 1934).

76. I. T. 2292, V-1 Cum. Bull. 12 (1926).

77. 2 Paul and Mertens, *op. cit. supra* note 35, at 209, § 17.82.

78. La. Act 21 of 1934, § 29(g) (2) [*Dart's Stats.* (1939) § 8587.29].

of the law presently reads "The term 'a party to a reorganization' includes a corporation resulting from a reorganization." The deleted portion of the federal act⁷⁹ continued ". . . and includes both corporations in the case of an acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation." The reason for this deletion is not apparent. If the legislators intended to limit the meaning of the term, their idea has not been adhered to in the Louisiana Rules and Regulations. This is evidenced by the fact that the article⁸⁰ commenting on this definitive subsection includes the deletion referred to and adds a word of explanation to the effect that "the definition is not an all-inclusive one, but simply enumerates certain cases with respect to which doubt might arise."⁸¹

The view that the definition is not all-inclusive has been voiced by the United States Board of Tax Appeals in interpreting the federal act. The Board has pointed out that the term "party to a reorganization" is not actually defined in the statute but that certain cases are simply enumerated. If the enumeration were regarded as all-inclusive, it would be extremely limiting.⁸² In the case before the Board at the time, Company A had acquired all the assets of Company B for stock and cash. The question was whether Company B was a "party to a reorganization." Answering in the affirmative, the Board took the view that though Company B was not expressly included, it was clearly a party to a merger, and that both parties to the merger must of necessity be parties to the reorganization of which the merger was the foundation.⁸³

Since the Louisiana law simply states that "a corporation resulting from a reorganization shall be included in the definition," the Louisiana courts may likewise adopt the view that this was merely inserted in the law to insure that such a corporation would not be omitted as a "party." Under such an interpretation they would be free to follow federal decisions as to who are deemed "parties."

Cases have arisen far more complex than those which are listed in the regulations as doubtful cases. The federal authorities

79. 47 Stat. 198, § 112 (i) (2) (1932).

80. La. Rules and Regulations concerning Income Taxes (1938) art. 181.

81. This is simply a copy of the comment as it appears in U.S. Treas. Reg. 77, Art. 577.

82. John S. Woodard, 30 B.T.A. 1216, 1223 (1934).

83. Ibid. See 47 Stat. 289, § 1111(b) (1932), 26 U.S.C.A. § 1696 (1938).

have been called upon to determine whether a holding company was a "party to a reorganization" where it had the stock of one of its operating companies issued to its stockholders, then deposited with a committee and finally exchanged by the committee for all the stock in a new company which it had organized. The court held that the holding company was a party.⁸⁴

There must, of course, result some immediate interest to a corporation if it is to qualify as a party to a reorganization. Thus, where an individual transferred his holdings in *A* and *B* corporations to a new *C* corporation, and thereafter the new corporation exchanged *A* and *B* shares with the *E* corporation for all the stock in *D* corporation, which shares were owned at the time by the *E* corporation, it was held that the *C* corporation was not a party to a reorganization since it merely exchanged with another corporation stock in two companies for stock which the other corporation owned, and neither acquired any definite interest in the other.⁸⁵

The meaning of the term "control" is of considerable importance in the Act.⁸⁶ This factor must be present to qualify a transaction as a non-taxable exchange under Subsection 29(b)(5) where no reorganization is involved but where there is a transfer of property to a corporation. It must likewise be present if a transaction is to qualify as a reorganization under Subsection 29(g)(1)(B)⁸⁷ and ultimately as a non-taxable exchange under Subsection 29(b)(4). As presently defined in the Louisiana law, Subsection 29(h),⁸⁸ control means "ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation." This was the definition which appeared in the federal acts of 1934⁸⁹ and prior thereto. Some ambiguity was detected in the phrase "80 per centum of the voting stock" inasmuch as it was not deemed clear whether this meant ownership of 80 per centum of the stock entitled to vote or ownership of stock having 80 per centum of the voting power. The latter interpretation is clearly more meaningful and in keeping with the common sense connotation of control. However, to avoid any possible contro-

84. *Sage v. Commissioner*, 83 F.(2d) 221 (C.C.A. 2nd, 1936), reversing *Charles H. Sage*, 31 B.T.A. 689 (1934).

85. *Bus and Transport Securities Corporation v. Helvering*, 296 U.S. 391, 56 S.Ct. 277, 80 L.Ed. 292 (1935).

86. La. Act 21 of 1934 [*Dart's Stats.* (1939) § 8587.1 et seq.].

87. Discussed *supra*, p. 220 et seq.

88. Copied from federal act, 47 Stat. 198, § 112(j) (1932).

89. 48 Stat. 705, § 112(h) (1934), 26 U.S.C.A. § 112 (1938).

versy thereunder, the Federal Act of 1936 was changed so as to make this meaning clear.⁹⁰ The Louisiana Act, although with the original wording, can be interpreted in accordance with the federal view.

As noted, a transfer which results in control immediately thereafter may qualify as a reorganization under Subsection 29(g) (1) (B) and hence as a tax-free exchange under Subsection 29(b) (4). However, Subsection 29(b) (5) recognizes such a transfer as a tax-free exchange without regard to its status as a reorganization. Why, then, would a corporation desire to use such a transfer as a reorganization so as to achieve nonrecognition under Subsection 29(b) (4) rather than Subsection 29(b) (5)? The reason appears upon examining the scope of Subsection 29(b) (4). This subsection grants nonrecognition to any corporate party to a reorganization where property is exchanged, exchanging solely for stock and securities in another corporation which is a party to the reorganization. Thus, if *one* transfer by a corporation of property for stock results in control and consequently qualifies as a reorganization within Subsection 29(g) (1) (B), other transfers which are a part thereof but which do not result in control, will be exempt within Subsection 29(b) (4) if made by corporations who are parties to the reorganization. The *Claude Neon Lights* case⁹¹ is a good illustration of a situation in which the federal counterpart of Subsection 29(b) (4) was used to this advantage. There, Corporation A controlled certain patents. To establish a new unit in the neon light business, Corporation B was formed to buy out Corporation C which was then functioning in the territory in which Corporation B was to operate. Corporation C transferred all its property to Corporation B solely in exchange for stock, and was thereafter in control. Consequently this qualified as a reorganization within Subsection 29(g) (1) (B) and as an exempt transaction within Subsection 29(b) (4). In addition, however, Corporation A transferred patent rights to B solely in exchange for stock but without acquiring a controlling interest. The Board ruled Corporation A a party to the reorganization since the patents were indispensable to Corporation B's operations, and exempted the exchange of patent rights for stock in Corporation B. Such an exchange could not have been exempted under Subsection 29(b) (5). Only the simple exchange between Corporations B and C would have been within its scope.

90. 49 Stat. 1681, § 112(h) (1936), 26 U.S.C.A. § 112 (1938). See 2 Paul and Mertens, *op. cit. supra* note 35, at 207, § 17.80.

91. 35 B.T.A. 424 (1937).

IV. SPECIAL PROVISIONS FOR EXCHANGES INVOLVING "BOOT"

In connection with each of the types of corporate exchanges outlined in Subsection 29(b),⁹² the Louisiana act specifies that in order to qualify for nonrecognition of gain or loss the property must be exchanged *solely* for property of like kind. Provision is also made in Subsections 29(c) and 29(d)⁹³ for those exchanges which are partially, but not solely, in kind. Gain on such an exchange is here recognized but only to the extent of the money and/or the fair market value of property other than property permitted to be received tax-free. Without some such provision an exchange would often be taxable merely because a small amount of money or property not permitted to be received tax-free was included in the exchange.

The first attempt to deal with this problem under the federal law appeared in the 1921 Act.⁹⁴ That act provided that in an exchange involving property and money in addition to property permitted to be received tax-free, the value of the other property and money should be deducted from the basis of the property permitted to be exchanged tax-free. If it exceeded such basis, the excess was taxable. This method achieved the same result as under the plan presently used, but usually deferred recognition of any gain until a final disposition. In 1923 the 1921 Act was amended⁹⁵ to adopt the current method⁹⁶ of dealing with such

92. La. Act 21 of 1934 [Dart's Stats. (1939) § 8587.1 et seq.].

93. La. Act 21 of 1934, § 29(c)(1) [Dart's Stats. (1939) § 8587.29]: "If an exchange would be within the provisions of Subsection (B) (1), (2), (3), or (5) of this Section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in amount not in excess of the sum of such money and the fair market value of such other property."

94. 42 Stat. 230, § 202(e) (1921): "Where property is exchanged for other property which has no readily realizable market value, together with money or other property which has a readily realizable market value, then the money or the fair market value of the property having such readily realizable market value received in exchange shall be applied against and reduce the basis, provided in this section, of the property exchanged, and if in excess of such basis, shall be taxable to the extent of the excess. . . ."

95. 42 Stat. 1560, c. 294, § 2 (1923): ". . . But when property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property of a readily realizable market value other than that specified in such paragraphs, the amount of the gain resulting from such exchange shall be computed in accordance with subdivisions (a) and (b) of this section, but in no such case shall the taxable gain exceed the amount of the money and the fair market value of such other property received in exchange."

96. The present plan in part defeats one of the purposes of tax-free exchanges which was to avoid the problem of valuation every time property is exchanged. If there is "boot" involved, all the property must be valued

exchanges; recognized gain was limited to the fair market value of the "boot" received.

In the 1932 Act⁹⁷ (copied by the Louisiana draftsmen) paragraph (1) of Subsection 112(c)⁹⁸ makes provision for recognition of gain where "boot" is involved in specific exchanges. Those so listed are: exchanges of property held for productive use or investment, stock for stock in the same corporation, stock for stock on reorganization, and property for stock where there is control immediately thereafter.

Paragraph (2)⁹⁹ of this subsection was added in 1924 in an attempt to plug a loophole which was brought to light while the Federal Act of 1921 was in effect. The purpose of the subsection can best be illustrated by indicating the type of tax avoidance which the subsection was designed to circumvent.

Suppose Corporation A has accumulated a substantial surplus which it would like to distribute to its stockholders as a dividend, but is restrained from so doing because of the surtaxes which will be levied thereon in the hands of the stockholders. Under the provisions of the 1921 Act¹⁰⁰ a new corporation could be organized and all the assets transferred to it with the agreement that the stockholders were to receive in exchange stock in the new corporation plus cash to the extent of the surplus of the old company. Under the 1921 Act the exchange of stock would be tax-free.¹⁰¹ The cash received would be taxable, but only as a capital gain at 12½ per centum¹⁰² rather than at surtax rates which far exceeded this modest percentage.¹⁰³

to determine whether a gain or loss has been incurred. This is true even though such gain, when determined, will be recognized only to the extent of such "boot." No loss whatever will be recognized. La. Act 21 of 1934, § 29 (c)(d) and (e).

97. 47 Stat. 196, § 112(c) (1932).

98. 47 Stat. 196 (1932); now La. Act 21 of 1934, § 29(c)(1) [Dart's Stats. (1939) § 8587.29], quoted in note 93, supra.

99. 47 Stat. 197 (1932); now La. Act 21 of 1934, § 29(c)(2): "If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after December 31, 1933. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

100. 42 Stat. 227 (1921).

101. 42 Stat. 230, § 202(c)(2) (1921): ". . . No gain or loss shall be recognized. . . (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from a reorganization."

102. 42 Stat. 1560, c. 294, § 2 (1923), quoted in note 95, supra.

103. I.T. 1833, II-2, Cum. Bull. 25 (1923).

To eliminate this practice paragraph (2) was enacted providing that where a distribution "has the effect of the distribution of a taxable dividend," the distributee shall pay a tax on it as a dividend, but only to the extent, in the federal law, of his ratable share of surplus accumulated after March 1, 1913.¹⁰⁴ The remainder of the gain recognized under paragraph (1) is taxed as an ordinary capital gain. In the Louisiana act,¹⁰⁵ the date from which the surplus must have been accumulated to come within the operation of the paragraph is fixed at December 31, 1933.

This paragraph must also be considered as regards its effect on the rule enunciated in Subsection 115(c).¹⁰⁶ This latter subsection provides that liquidating dividends shall be regarded as in full payment in exchange for the stock and that the transaction shall be taxable as an ordinary capital exchange involving gain or loss. It was argued by the federal administration that this provision had the effect of taxing liquidating dividends as capital gains even though the stockholder thereby had returned to him a pro-rata share of assets which could have been declared as a dividend.¹⁰⁷ The Federal Board of Tax Appeals has held,¹⁰⁸ however, that paragraph (2) of Subsection 112(c)¹⁰⁹ modifies this general rule and requires that such portion of a liquidating dividend as represents surplus accumulated since March 1, 1913, shall be taxable as an ordinary dividend. The effect of this ruling is to exempt from the normal tax that portion of a liquidating dividend which it would bear as a capital gain, and subject it only to the surtax as in the case of dividends generally.¹¹⁰ Although these sections¹¹¹ were copied by the Louisiana draftsmen, they might well have been omitted. The tax will be the same by either procedure under the Louisiana act since there is no surtax provision and both capital gains and dividends are taxed at the same rates.¹¹² These provisions, hence, serve no useful purpose in the Louisiana law.

104. *Supra*, note 99.

105. La. Act 21 of 1934, § 29(c)(2) [Dart's Stats. (1939) § 8587.29].

106. 47 Stat. 204, § 115(c) (1932); now La. Act 21 of 1934, § 32(c) [Dart's Stats. (1939) § 8587.32].

107. John S. Woodard, 30 B.T.A. 1216, 1225 (1934).

108. 30 B.T.A. at 1227.

109. 47 Stat. 197 (1932); now La. Act 21 of 1934, § 29(c)(2) [Dart's Stats. (1939) § 8587.29].

110. John S. Woodard, 30 B.T.A. 1216, 1228 (1934).

111. 47 Stat. 196, 204, § 112(c), § 115(c) (1932); now La. Act 21 of 1934, §§ 29(c), 32(c) [Dart's Stats. (1939) §§ 8587.29, 8587.32].

112. La. Act 21 of 1934, § 5 [Dart's Stats. (1939) § 8587.5].

Subsection 112(d)¹¹³ of the Federal Act was made necessary to alleviate the double taxation problem arising in connection with exchanges of property for stock by a reorganizing corporation.¹¹⁴ Since a corporation is a legal entity apart from the stockholders, if it received "boot" in connection with an exchange, gain would be recognizable to this extent, even though the "boot" was immediately distributed to the stockholders.¹¹⁵ As a consequence Subsection 112(d) was added and provides that if the "boot" is distributed in pursuance of the plan of reorganization, no gain will be recognized¹¹⁶ to the corporation. However, the threat of double taxation is still present, inasmuch as a failure to distribute in connection with the plan of reorganization, even though done independently later, will result in tax, first to the corporation, and second to the stockholder as a liquidating dividend.¹¹⁷

The Federal Act of 1932 contained an additional provision dealing with distributions to stockholders which it is pertinent to mention here. Subsection 112(g)¹¹⁸ provided for the non-recognition of gain to a stockholder upon the receipt of new stock distributed pursuant to a plan of reorganization, providing that the old stock was not surrendered.

113. 47 Stat. 197, § 112(d) (1932); now La. Act 21 of 1934, § 29(d) [Dart's Stats. (1939) § 8587.29]: "If an exchange would be within the provisions of Subsection (b) (4) of this Section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without recognition of gain, but also of other property or money, then—

"(1) If the corporation receiving such other property or money distributes it in pursuance of the plan or reorganization, no gain to the corporation shall be recognized from the exchange, but

"(2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property so received, which is not so distributed."

114. House Ways and Means Committee Rep. No. 179, 68th Cong., 1st Sess. (1924) 15; Senate Finance Comm. Rep. No. 398, 68th Cong., 1st Sess. (1924) 16.

115. 47 Stat. 196, § 112(c)(1) (1932); now La. Act 21 of 1934, § 29(c)(1) [Dart's Stats. (1939) § 8587.29].

116. National Pipe & Foundry Co., 19 B.T.A. 242 (1930). Subsection 112(d) (1) was Subsection 203(e)(1) in the 1926 Act.

117. West Texas Refining & Development Co. v. Commissioner, 68 F.(2d) 77 (C.C.A. 10th, 1933).

118. 47 Stat. 197, § 112(g) (1932): "If there is distributed, in pursuance of a plan or reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or securities shall be recognized."

This provision was originally made in the 1924 Act,¹¹⁹ allegedly to facilitate the division of corporate enterprises into smaller units without necessitating dissolution of the original corporation. Corporation A might desire to organize Corporation B and transfer a portion of its assets thereto and distribute the stock of the B Corporation to the old stockholders. This, however, would constitute a taxable dividend to the stockholders of A,¹²⁰ although they have received nothing more than that to which their old stock entitled them. On the other hand, had the A Corporation organized two new corporations, transferred all of its assets to them, and distributed the stock of the new corporations to the old stockholders in liquidation, the transaction would have been tax-free.¹²¹ To avoid this anomalous situation, the former type of transfer was also made tax-free in the 1924 Act.

In providing for this anomaly, however, the subsection added in 1924 and retained until 1934 resulted in inadvertently deferring the tax on certain other corporate distributions. Thus, for example, a corporation contemplating liquidation might transfer almost all of its properties for stock and cash to one corporation and the remainder to a new corporation. Without requiring the surrender of the old stock, stock in this new corporation could be distributed to the old stockholders and was tax-free within Subsection 112(g).¹²² Later, the stock and cash received on the first transfer could be distributed as a liquidating dividend within Subsection 115(c).¹²³ If gain to the stockholders resulted thereon, tax would be payable, but employment of this method resulted in rendering taxable only part of the gain on the distribution of the original assets.¹²⁴

To cope with this problem the 1934 Act¹²⁵ omitted the above provision, despite the fact that the effect was to restore the original anomaly referred to. Although in other parts of the Louisiana capital gains section the Federal Act of 1932 was relied upon, in this instance the state draftsmen apparently followed the Federal Act of 1934, and likewise omitted Subsections 112(g) and 112

119. 43 Stat. 256, § 203(c) (1934), 26 U.S.C.A. § 112 (1938).

120. Senate Finance Comm. Rep. No. 398, 68th Cong., 1st Sess. (1924) 15.

121. 43 Stat. 256, § 203(b)(2) (1924), 26 U.S.C.A. § 112 (1938): "No gain or loss shall be recognized if stock or securities . . . are, in pursuance of the plan or reorganization, exchanged solely for stock or securities. . . ."

122. 45 Stat. 818, § 112(g) (1928), same as 1932 Act quoted in note 118, *supra*; North American Utility Securities Corp., 36 B.T.A. 320 (1937); Rudolph Boehringer, 29 B.T.A. 8 (1933).

123. 45 Stat. 822 (1928); La. Act 21 of 1934, § 32(c) [Dart's Stats. (1939) § 8587.32]. North American Utility Securities Corp., 36 B.T.A. 320, 325 (1937).

124. North American Utility Securities Corp., 36 B.T.A. 320 (1937).

125. 48 Stat. 705 (1934).

(h)¹²⁶ which contained the exemption referred to. The Louisiana Regulations,¹²⁷ however, contain explanatory paragraphs commenting upon the type of exemption in Subsection 112(g).¹²⁸ The regulations also provide at some length the basis for gain or loss upon the subsequent sale of such stock received tax-free in connection with a reorganization. Since the subsection¹²⁹ is not contained in the law, the allusions to it in the regulations may be disregarded. However, Article 193, which provides a basis for stock so received when subsequently sold, is also referred to and made applicable in computing gain or loss upon the subsequent sale of stock received as an ordinary stock dividend.¹³⁰ This portion of the regulation therefore should be retained.

V. ADJUSTED BASIS OF PROPERTY RECEIVED UPON TAX-FREE CORPORATE EXCHANGE, SECTION 30

The assumption is sometimes mistakenly made by taxpayers that there is an inherent advantage in bringing a transaction within the category of a tax-free exchange on the theory that a tax saving will necessarily result. This view can ordinarily be attributed to a confusion of tax-free exchanges with actual tax exemptions. It was never the intent in the federal acts to grant exemptions. This is witnessed by the increasingly elaborate precautions taken in the federal acts for taxing all gain resulting to the taxpayer upon final disposition of the property, whether that gain occurred before or after the "tax-free exchange." The actual purpose was, of course, merely to defer the tax on a gain resulting to a taxpayer until that gain was deemed to be realized by a sale of the property for money or for other property not permitted to be received tax-free.¹³¹ The object of the legislators was to defer the tax until realization, without exempting any of the gain from tax. The statutes accomplished this by requiring that the new property take the basis of the property for which it was exchanged.¹³² This requirement constitutes an exception

126. 47 Stat. 197 (1932).

127. La. Rules and Regulations Concerning Income Taxes (1938). Copied from U.S. Treas. Reg. 77.

128. La. Rules and Regulations concerning Income Taxes (1938), art. 193.

129. 47 Stat. 197, § 112(g) (1932). Subsection 29(g) in La. Act 21 of 1934 [Dart's Stats. (1939) § 8587.29] contains the "Definition of Reorganization."

130. La. Rules and Regulations concerning Income Taxes (1938) art. 205.

131. House Ways and Means Committee Rep. No. 179, 68th Cong., 1st Sess. (1924) 16. See Jacobson and Johnson, *Pyramiding Gains and Losses through Tax-Free Exchanges* (1936) 14 N.Y.U. Law Q. Rev. 59.

132. In the case of gifts the object is accomplished by requiring the donee to retain the donor's basis, La. Act 21 of 1935, § 30(a) (2) [Dart's Stats. (1939) § 8587.30].

to the general rule that gain shall be computed on the basis of cost.¹³³ In the case of an exchange, cost normally would be the fair market value of the property given in payment. The function of Section 30 of the Louisiana Act is to prescribe the circumstances under which an adjusted basis must be substituted for cost or fair market value by the taxpayer.

As was the case in connection with Section 29, the full significance of the Louisiana provision for adjusted basis requires an examination of its counterpart in the federal law and some inquiry into the stages through which it passed before attaining its present form.

The Federal Act of 1918 incorporated the principle of "tax-free exchanges" only to a very limited degree in connection with corporate reorganizations.¹³⁴ As a consequence only a very simple statement as to the basis of the property exchanged sufficed. The Act provided merely that "new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged."¹³⁵ In 1921, exchanges of property held for productive use or investment and exchanges of property for stock in a controlled corporation¹³⁶ were added to the list of tax-free exchanges. No change was then made in the language providing for an adjusted basis except in those cases where "boot" was received.¹³⁷

In the 1921 Act and prior thereto, where an exchange involved the receipt of money and property in addition to property permitted to be received tax-free, the method provided for determining adjusted basis was simply to deduct the fair market value of such other property from the cost of the property exchanged.¹³⁸ The remainder constituted the basis for subsequent disposition, and if such other property exceeded the cost of the property exchanged, the excess was taxable. This policy was changed in the 1924 Act and the method for dealing with exchanges involving "boot" which is now in use was evolved.¹³⁹ Gain was now to be recognized in connection with exchanges involving "boot" to the extent of the fair market value of such "boot." This simply meant that if the value of the property per-

133. La. Act 21 of 1934, § 30(a) [Dart's Stats. (1939) § 8587.30].

134. 40 Stat. 1060, § 202(b) (1918).

135. *Ibid.* Quoted in note 26, *supra*.

136. 42 Stat. 230, § 202(c)(1)(2)(3) (1921).

137. *Id.* at § 202(e). The new basis of computing gain where "boot" is involved is discussed *supra*, p. 228 et seq.

138. *Ibid.*

139. 43 Stat. 257, § 203(d) (1924), 26 U.S.C.A. § 112 (1938), copied in La. Act 21 of 1934, § 29(a)(6) [Dart's Stats. (1939) § 8587.29].

mitted to be received tax-free, plus the value of the "boot," exceeded the cost of the property exchanged therefor, such excess would be taxable but only to the extent of the value of the "boot." Previously the value of the "boot" would have had to exceed the cost of the original property in order for a taxable gain to result.¹⁴⁰ This change made necessary an additional provision in the subsection dealing with tax-free exchanges generally. Language was added to the effect that "the basis shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made."¹⁴¹ That is, if a taxpayer had a farm which cost him \$10,000 and he exchanged it for a \$5,000 farm plus \$6,000 in bonds and \$1,000 in cash, his gain would be \$2,000 ($\$5,000 + \$6,000 + \$1,000 - \$10,000 = \$2,000$). The total gain would be recognized since it is less than the "boot" (\$6,000 bonds, \$1,000 cash) which the taxpayer receives. The formula must provide an adjusted basis for the new property of the taxpayer from which has been excluded any return of capital in the form of cash and which will include any increases in value on which tax has been paid. This is accomplished by deducting from the original capital of \$10,000 the \$1,000 received in cash and adding the \$2,000 gain on which tax has been paid. ($\$10,000 - \$1,000 + \$2,000 = \$11,000$). In the event that he later disposes of the farm and bonds for \$15,000 cash, the adjusted basis would be \$11,000 and he would then have a taxable gain of \$4,000. The accuracy of the results can be readily checked by recalling that he has received in return for a farm which cost him \$10,000 a total of \$16,000 in cash or a total taxable gain of \$6,000. He paid tax on \$2,000 of this gain at the time of the tax-free exchange and on \$4,000 at the time the farm and bonds were disposed of for cash.

The problem of apportionment raised in the above illustration is also provided for in the same subsection:¹⁴² "If the property so acquired consists in part of the type of property permitted by Subsection 29 (b) to be received without the recognition of gain or loss, and in part of other property, the basis provided in this paragraph shall be allocated between the properties (other

140. 42 Stat. 230, § 202(e) (1921); quoted in note 94, *supra*.

141. 43 Stat. 257, § 203(d) (1924), 26 U.S.C.A. § 112 (1938); now La. Act 21 of 1934, § 30(a)(6) [Dart's Stats. (1939) § 8587.30].

142. La. Act 21 of 1934, § 29(a)(6) [Dart's Stats. (1939) § 8587.29].

than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange." Thus the bonds received would take as a basis their fair market value of \$6,000 and the remainder of the total adjusted basis (\$5,000) would be assigned to the farm. This will normally be the fair market value of the farm at the date of exchange. Obviously, the formula does not eliminate the necessity for valuing both the bonds and the farm since the total value is necessary to a determination of the gain.¹⁴³

Referring back to the first sentence quoted from Subsection 30(a)(6) in which the formula for adjusted basis is set out, the last phrase of that sentence is worth noting: ". . . increased in the amount of gain . . . or decreased in the amount of loss . . . that was recognized . . . under the law applicable to the year in which the exchange was made." The significance of this language is that the law applicable to the year in which the exchange was made is involved, not to fix the basis, but only to determine the amount of gain or loss recognized in that year. This gain or loss is then added to or subtracted from the basis calculated under the law in effect, not when the exchange took place, but when the sale or other disposition occurred.¹⁴⁴ Under the present Louisiana Act this language has no significance since the same act governs both the exchange and the subsequent sale. However, subsequent changes in basis in later acts would render the provision important.¹⁴⁵

There were also considerations other than the problems just discussed which prompted an expansion of the federal provisions dealing with the "adjusted basis" in tax-free exchanges. The 1921 Act had simply provided that in a tax-free exchange the property received should be treated as taking the place of the property exchanged therefor.¹⁴⁶ However, where the property was exchanged for stock in a new corporation it was apparent that this statement was inadequate to prevent wholesale tax avoidance. The taxpayer's basis for the new stock received would be, as

143. *Supra*, note 96.

144. *Securities Co. v. Commissioner*, 64 F.(2d) 330 (C.C.A. 2nd, 1933); S.M. 2723, III-2 Cum. Bull. 26 (1924).

145. In the federal law the method of computing a basis as established in the Revenue Act of 1932 is applied to all property acquired subsequent to February 28, 1913, and prior to January 1, 1934, thereby injecting a degree of uniformity into the computation. 48 Stat. 708, § 113(a)(12) (1934), 26 U.S.C.A. § 113(a)(12) (1938).

146. 42 Stat. 230, § 202(d)(1) (1921).

contemplated, the cost of the property parted with for stock.¹⁴⁷ The basis of the property in the corporation's hands, however, was governed by the general rule that where a corporation acquires property for its stock, the cost of the property shall be the fair market value of the stock at the date of acquisition.¹⁴⁸ As a consequence, it was possible under the 1921 Act for a taxpayer, owning property which had largely increased in value, to organize a corporation, transfer the property thereto, and then have the corporation sell the property. By this method the owner paid a tax only on the increase in value while in the hands of the corporation.¹⁴⁹ Of course the stock received by the owner could not be sold without incurring a tax on the total gain, but the proceeds of the sale by the corporation could be distributed to the stockholder in piecemeal amounts and in taxable periods when losses could be strategically used to cancel out any gains resulting. To cope with this situation two new subsections were incorporated into the Federal Act of 1924, specifically directed at providing an adjusted basis for property transferred to a corporation in return for stock.¹⁵⁰ Such transfers were also specifically excluded from the subsection covering tax-free exchanges generally.¹⁵¹

The federal draftsmen originally directed their efforts at two types of exchanges in which property was acquired by a corporation in exchange for its stock: (1) in connection with a reorganization in which the same control was continued and (2) in connection with a simple transfer of property to a corporation, accompanied by control immediately thereafter. These, of course, are the types of exchanges which had already been rendered tax-free under previous acts¹⁵² and are covered in the present Louisiana Act¹⁵³ in Subsections 29(b) (4) and 29(b) (5). As enacted in the federal law,¹⁵⁴ the original of Subsection 30(a) (7) in the Louisiana Act read:

"Sec. 204(a) (7). If the property (other than stocks or

147. *Ibid.* There would be no difficulty here since the old stock replaced would have a determinable value in the hands of the individual stockholder.

148. This followed in view of the fact that unissued stock of a corporation has no value of itself and therefore its value in the hands of the issuing corporation could not be assigned to the property acquired therefor. See *Jankowsky v. Commissioner*, 56 F.(2d) 1006, 1008 (C.C.A. 10th, 1932); *Peter Doelger Brewing Company, Inc.*, 22 B.T.A. 1176 (1931).

149. G.C.M. VII-1 Cum. Bull. 193 (1928).

150. 43 Stat. 259, § 204(a)(7) and (8) (1924), 26 U.S.C.A. §§ 113, 114 (1938).

151. 43 Stat. 258, § 204(a)(6) (1924), 26 U.S.C.A. §§ 113, 114 (1938).

152. 42 Stat. 230, § 202(c)(1) and (2) (1921).

153. La. Act 21 of 1934 [*Dart's Stats.* (1939) § 8587.1 et seq.].

154. 43 Stat. 259 (1924).

securities in a corporation a party to the reorganization) was acquired after December 31, 1917, by a corporation in connection with a reorganization, and immediately after the transfer an interest or control of 80 per centum or more remained in the same persons or any of them, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made."

The companion subsection provided:¹⁵⁵

"Sec. 204(a) (8). If the property (other than stock or securities in a corporation a party to a reorganization) was acquired after December 31, 1920, by a corporation by the issuance of its stock or securities in connection with a transaction described in paragraph (4) of subdivision (b) of Section 203¹⁵⁶ . . . then the basis shall be the same as it was in the hands of the transferor. . . ."

Did the new provisions accomplish their purpose? Unhappily for the tax collectors, only in part. A "stepped-up" basis could not now be secured by transferring, to a corporation, property other than stock or securities if the transfer was in connection with a reorganization or accompanied by control. By a curious inadvertence, however, the federal draftsmen excluded from all three subsections dealing with basis provision¹⁵⁷ a type of corporate acquisition rendered tax-free by a specific provision elsewhere in the law.¹⁵⁸ No satisfactory explanation has been given for the parenthetical exclusion of stock or securities in a corporation a party to a reorganization, from both the sections quoted.¹⁵⁹ The result, however, was to leave a loophole in the law through which an astute legal craftsman could steer his client to substantial tax savings.

155. *Ibid.*

156. Now 48 Stat. 704, § 112(b)(5) (1934), 26 U.S.C.A. § 112 (1938) and La. Act 21 of 1934, § 29(b)(5) [Dart's Stats. (1939) § 8587.29].

157. 43 Stat. 258, § 204(a)(6)(7) and (8) (1924), 26 U.S.C.A. §§ 113, 114 (1938).

158. 43 Stat. 256, § 203(b)(2) (1924), 26 U.S.C.A. § 112 (1938): "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."

159. House Ways and Means Committee Rep. No. 2, 70th Cong. 1st Sess. (1928) 18.

A case passed upon by the Federal Board of Tax Appeals¹⁶⁰ illustrates the method pursued. *P* was the owner of an option on oil lands which had substantially increased in value since its acquisition. In order to dispose of it without incurring an immediate and sizeable taxable gain, *P* organized the *H* Corporation and transferred the option to it in exchange for all the stock. He then organized the *S* Corporation and exchanged the *H* stock for all of its stock. A third corporation, the *Stires* Corporation, was then organized and *P* purchased its stock for cash. The *Stires* Corporation then purchased all of the *H* stock from *S* for cash. Finally, *Stires* Corporation dissolved the *H* Corporation, receiving the oil option which was its only asset. The *Stires* Corporation then sold the oil option and claimed no taxable gain resulted to it because the option had as a basis in its hands its fair market value at the time the *H* stock was acquired by *S*, at which fair market value it was sold. The gist of the argument for this new basis was that the exchange of the stock of the *S* Corporation for stock of *H* constituted a reorganization within Subsection 203(b) (2)¹⁶¹ and 203(h) (1) (A) and (2).¹⁶² The exchange was therefore tax-free. Because of the parenthetical exclusion of stock and securities acquired by a corporation on reorganization in Subsection 204(a) (7),¹⁶³ however, *S* Corporation was not limited to the transferor's basis for the *H* shares but acquired a new basis, namely, the fair market value of the stock at the time of the exchange. The allegation was further made that this basis continued in the hands of the *Stires* Corporation. As a consequence, when the *H* Corporation was liquidated and the option acquired by *Stires*, the basis likewise was the fair market value of the *H* stock at the time it was exchanged for the stock of *S*. The Board of Tax Appeals¹⁶⁴ sustained this argument with the result that the *Stires* Corporation paid practically no tax. *P*, the original owner, of course, would not be liable for any tax until distributions were made by the *Stires* Corporation.

Congress added new language to Subsection 113(a) (7)¹⁶⁵ in

160. *Stires Corporation*, 28 B.T.A. 1 (1933), appeal to C.C.A. 2nd dismissed.

161. 44 Stat. 12, § 203(b) (2) (1926), 26 U.S.C.A. § 112 (1938); now La. Act 21 of 1934, § 29(b) (3) [Dart's Stats. (1939) § 8587.29].

162. *Ibid.*, § 203(h) (1) (A) and (2); now La. Act 21 of 1934, § 29(g) (1) (A), and (2) [Dart's Stats. (1939) § 8587.29].

163. *Supra*, p. 238.

164. *Stires Corporation*, 28 B.T.A. 1 (1933). For the opinion on which the case was based, see G.C.M. 7285, IX-1 Cum. Bull. 181.

165. In 1928 the sections of the Act were renumbered so that § 204(a) (6), 204(a) (7), and 204(a) (8) became § 113(a) (6), 113(a) (7), 113(a) (8). 45 Stat. 818 (1928), 26 U.S.C.A. § 113 (1938).

the Federal Act of 1928 in an attempt to close the loophole just illustrated and prevent the acquisition of a "stepped-up" basis through reorganization. They omitted the parenthetical exclusion from both Subsections 113(a) (7) and (8) and added the following sentence to Subsection 113(a) (7):¹⁶⁶

"Sec. 113(a) (7) . . . This paragraph shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer."

No difficulty in understanding the wording of this amendment will be encountered if it is recalled that Subsection 113(a) (7) was originally added in 1924 to prevent the acquisition of a "stepped-up" basis for property, other than stock, by transfer to a corporation in exchange for stock. The "step-up" had been achieved by virtue of the general rule that property acquired by a corporation for stock took the fair market value of the stock at the date of the exchange as a basis. This necessarily followed, since prior to an exchange unissued stock would have had no value whatsoever. To avoid the application of this rule, Subsections 113(a) (7) and (8) provide that the property shall continue to have the same basis in the hands of the corporation as it had in the hands of the transferor instead of "the same basis as in the case of the property exchanged" as provided in Subsection 113(a) (6). Additional provision for the basis of the stock in the hands of the recipient was unnecessary since this basis was still supplied under the general statement of basis in Subsection 113(a) (6). Only property received *by a corporation* in exchange for stock is excepted from this subsection.¹⁶⁷ As a consequence, the type of exchange rendered tax-free by Subsection 112(b) (4)¹⁶⁸ is taken care of as to basis under Subsections 113(a) (6) and (7). Subdivision (6) provides an adjusted basis of cost of the property exchanged to the transferor for the stock which is

166. 45 Stat. 819 (1928).

167. 48 Stat. 706, § 113(a)(6) (1934); 26 U.S.C.A. § 113(a)(6) (1938): ". . . Upon an exchange . . . the basis shall be the same as in the case of the property exchanged. . . . This paragraph shall not apply to property acquired by a corporation by the issuance of its stock or securities as the consideration in whole or in part for the transfer of the property to it."

168. 48 Stat. 704, § 112(b)(4) (1934), 26 U.S.C.A. § 112(b)(4) (Supp. 1938). This was § 203(b)(3) previously; 43 Stat. 256 (1924), 26 U.S.C.A. § 934 (1925). "No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

received,¹⁶⁹ and Subdivision (7)¹⁷⁰ provides an adjusted basis of cost to the transferor for the property acquired by the corporation.

Now if it is recalled that the amendment to Subsection 113 (a) (7) was inserted to bring within the operation of this subdivision stocks and securities received by a corporation on reorganization in exchange for its own stocks and securities, but without also bringing in the type of transaction described in Subsection 112(b) (4) which already had been cared for, the significance of the amendment is apparent. Stated conversely, it would read: This paragraph shall apply to stocks and securities in a corporation a party to the reorganization, acquired by a corporation in exchange for its stock and securities, but *not* to stocks and securities in a corporation a party to a reorganization acquired by a corporation in exchange for property other than its stock and securities.

The loophole for attaining a "stepped-up" basis contained in Subsection 113(a) (8)¹⁷¹ was plugged simply by striking out the parenthetical exclusion of "stocks or securities in a corporation a party to a reorganization," thereby bringing within the scope of Subsection 113(a) (8) a transfer of any type of property if, after the transfer, there was control by the transferor as defined in Subsections 112(b) (5) and 112(h).¹⁷² Since this subsection, by its terms, was limited to property acquired by a corporation "by the issuance of its stocks or securities," there was no necessity to specifically exclude the type of acquisition described in Subsection 112(b) (4), namely, the acquisition by a corporation of stocks or securities in exchange for other property on reorganization.

If an acquisition by a corporation for stock or securities is neither in connection with a reorganization¹⁷³ nor accompanied by control¹⁷⁴ by the transferor, the general rule still applies, and the basis of the property will be its fair market value at the time

169. *Faris v. Helvering*, 71 F.(2d) 610, 612 (C.C.A. 9th, 1934).

170. 48 Stat. 707, § 113(a)(7) (1934), 26 U.S.C.A. § 113(a)(7) (1938). "If the property was acquired . . . by a corporation in connection with a reorganization . . . then the basis shall be the same as it would be in the hands of the transferor. . . ."

171. 48 Stat. 707 (1934), 26 U.S.C.A. § 113 (Supp. 1938), quoted as § 204(a) (8), *supra*, p. 238.

172. 48 Stat. 704, 705 (1934), 26 U.S.C.A. § 112 (Supp. 1938).

173. 48 Stat. 704 §§ 112(b) (3) and 112(b) (4) (1934); now La. Act 21 of 1934, § 29(b)(3), 29(b)(4) [Dart's Stats. (1939) § 8587.29].

174. 48 Stat. 704, § 112(b)(5); now La. Act 21 of 1934, § 29(b)(5) [Dart's Stats. (1939) § 8587.29].

of acquisition.¹⁷⁵ The exchange would not be tax-free from the standpoint of the recipient of the stock however. If the exchange resulted in a gain, it would be taxable. In other words, in the absence of the factor of control or reorganization an exchange of property for stock would be deemed to be a change in substance rather than form, and would come within the purview of the section declaring an exchange taxable unless specifically excepted.¹⁷⁶

Denied access to a "stepped-up" basis and its resultant tax savings, through the relatively easily arranged "reorganizations" illustrated in the *Stires* case,¹⁷⁷ the professional tax "avoiders" sharpened their weapons for a new attack on the statute. In the 1928 Act, whether an acquisition by a corporation was in connection with a reorganization accompanied by control¹⁷⁸ or whether it was a simple transfer with control in the transferor thereafter,¹⁷⁹ it would be included in the subsections requiring an adjusted basis only if the statutory definition of "control" was complied with. As then defined,¹⁸⁰ control in both Subsections 112(i) (1) (B) and 112(b) (5)¹⁸¹ meant "ownership of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of the corporation."

The theory of attack developed was to arrange a transfer so that it would come within the confines of one of the tax-free exchanges as a reorganization¹⁸² but with the holdings of stocks and securities so arranged that the definition of "control," as used in Subsection 113(a) (7), would not be complied with. If the exchange was excluded from this provision, the general rule of fair

175. *Ambassador Petroleum Company*, 28 B.T.A. 868 (1933); 2 Paul and Mertens, op. cit. supra note 35, at 271, 396, §§ 18.19, 18.120.

176. 48 Stat. 704, § 112(a) (1934), 26 U.S.C.A. § 112(a) (1934); now La. Act 21 of 1934, § 29(a) [Dart's Stats. (1939) § 8587.29]: "Upon the sale or exchange of property the entire amount of the gain or loss . . . shall be recognized, except as hereinafter provided in this section."

177. *Stires Corporation*, 28 B.T.A. 1 (1933).

178. That is, a corporate exchange of stock for stock or property would constitute a statutory reorganization if the requisite control were present. 45 Stat. 818, § 112(i) (1) (1928): "The term 'reorganization' means . . . (B) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control. . . ."

179. 45 Stat. 816, § 112(b) (5) (1928), 26 U.S.C.A. § 112 (Supp. 1938).

180. 45 Stat. 818, § 112(j) (1928), 26 U.S.C.A. § 113 (Supp. 1938); now La. Act 21 of 1934, 29(h) [Dart's Stats. (1939) § 8587.29].

181. La. Act 21 of 1934, §§ 29(g) (1) (B), 29(b) (5) [Dart's Stats. (1939) § 8587.29].

182. That is within § 112(b) (3) or 112(b) (4), 45 Stat. 816 (1928), 26 U.S.C.A. § 112 (Supp. 1938).

market value at date of acquisition would be applicable, with the desired result of a "stepped-up" basis and a postponement¹⁸³ of tax.

The *Handbird Holding Company* case¹⁸⁴ aptly illustrates this method of attack. *G* Corporation wished to dispose of its property to *P* Corporation and *P* agreed to collaborate in a plan to avoid part of the tax for which *G* would thereby become liable. *G* organized two new corporations, *F* and *H*. *G* then transferred the assets to *F*, in exchange for all its stock. This was alleged to constitute a reorganization within Subsections 112(i)(1)(B) and 112(b)(4)¹⁸⁵ and therefore tax-free. The property in *F*'s hands consequently would have the same basis as in the hands of the transferor, *G*, under Subsection 113(a)(7).¹⁸⁶ The second new corporation, *H*, then sold one-third of its stock together with certain bonds to *P* Corporation, the prospective purchaser.¹⁸⁷ *H* Corporation then purchased the assets of *G* from *F*, giving in return two-thirds of its stock and a quantity of bonds. This exchange was also alleged to be a reorganization within Subsection 112(i)(1)(A) and 112(b)(4)¹⁸⁸ and hence tax-free. However, it was alleged that the property in *H*'s hands could not take the transferor's base under Subsection 113(a)(7) because *F* had only 66 2/3 per centum control of the stock and 38 per centum control of the bonds of *H* Corporation whereas 80 per centum was required by the subsection. It was therefore alleged that the assets in *H*'s hands took the fair market value at date of transfer as a basis. Finally, *H* transferred the assets to the *P* Corporation in exchange for cash and the stock and bonds previously issued to *P*. *H* then reported as taxable gain the difference between the fair market value of the property when acquired from *F* and the

183. A postponement rather than a tax exemption since a sale of the stock by the stockholder at a later date would result in a taxable gain.

184. 32 B.T.A. 238 (1935).

185. 45 Stat. 818 (1928), 26 U.S.C.A. § 112 (Supp. 1938); now La. Act 21 of 1934, §§ 29(g)(1)(B), 29(b)(4) [Dart's Stats. (1939) § 8587.29]; under subdivision 112(i)(1)(B) there must be statutory control to constitute a reorganization.

186. 45 Stat. 819, § 113(a)(7) (1928); now La. Act 21 of 1934, § 30(a)(7) [Dart's Stats. (1939) § 8587.30]: "If . . . after the transfer an interest or control in such property of 80 per centum or more remained in the same persons . . . then the basis shall be the same. . . ."

187. In the actual case there was an additional corporation formed by *P* to make the purchase, but its elimination does not alter the principles involved.

188. 45 Stat. 816, 818 (1928); now La. Act 21 of 1934, §§ 29(g)(1)(A), (b)(4) [Dart's Stats. (1939) § 8587.29]; under Subdivision 112(i)(1)(A) there need only be acquisition of a majority of the voting and non-voting stock of a corporation or acquisition of substantially all of its properties to constitute a reorganization.

value of the cash and securities received from the S Corporation. The H Corporation was then dissolved, its mission having been accomplished.

Had the Federal Board of Tax Appeals been left undisturbed by the Supreme Court, the Board probably would have sustained the contention of the taxpayer that a "stepped-up" basis had been legitimately achieved. In the *Gregory* case¹⁸⁹ two years earlier the Commissioner of Internal Revenue had argued for disregarding corporate entities which were created for the sole purpose of tax avoidance and which were discarded when this had been accomplished. In that case a statutory reorganization admittedly was engineered for the purpose of tax avoidance. The Board there said:¹⁹⁰

"Congress has not left it to the Commissioner to say, in the absence of fraud or other compelling circumstances, that the corporate form may be ignored in some cases and recognized in others. Whatever can be said of the wisdom of recognizing the corporate device, the taxing statutes have so plainly accepted it and provided the detailed methods of taxing its transactions that to disregard it in a case like this would vary the time, method, and amount of tax which the statute imposes."

The Board thus expressly approved the use of the corporate device to contrive an exchange which would not fall within the precise terms of the law. Such corporations would not be disregarded even though their only purpose was tax avoidance. This point of view was an open invitation to tax specialists to pit their ingenuity against that of the department draftsmen. The *Handbird* case well illustrates the effects of the challenge.

In the two-year interval between the *Gregory* case and the *Handbird* case, however the *Gregory*¹⁹¹ case reached the Supreme Court and elicited an opinion which dealt a body blow to reorganization staged solely for tax avoidance. Justice Sutherland, speaking for the Court there, said in part:¹⁹²

"When [the act] speaks of a transfer of assets by one corporation to another, it means a transfer made in pursuance of a plan of reorganization of corporate business; and not a trans-

189. Evelyn F. Gregory, 27 B.T.A. 223 (1932).

190. 27 B.T.A. at 225.

191. *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

192. 293 U.S. at 469-470, 55 S.Ct. at 268, 79 L.Ed. at 599.

fer of assets by one corporation to another in pursuance of a plan having no relation to the business of either, as plainly is the case here . . . The whole undertaking, though conducted according to the terms of [the act], was in fact an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else. The rule which excludes from consideration the motive of tax avoidance is not pertinent to the situation, because the transaction upon its face lies outside the plain intent of the statute. To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose."

Two months after the Court had spoken on the *Gregory* case, the Board promulgated its opinion in the *Handbird Holding Corporation* case.¹⁹³ Bowing to the ruling of its superior court, the Board found that the creation of the *F* and *H* Corporations by *G* was a subterfuge and bore no relationship to the business of *G*. The transfer by *F* to *H*, instead of constituting a reorganization, was held to be a transfer with immediate control thereafter in the transferor and hence tax-free within Subsection 112 (b) (5)¹⁹⁴ but with the transferor's basis retained under Subsection 113 (a) (8).¹⁹⁵ The temporary holding by the *P* Corporation of one-third of the stocks and a part of the bonds so as to defeat the "80 per centum" clause in the definition of control was brushed aside as without substance inasmuch as *P*'s holdings were relinquished immediately upon the receipt of the assets from *H*. Thus the transfer was held to fall squarely within Subsections 112 (b) (5) and 113 (a) (8). The result was a taxable gain to *H* of the difference between the original cost to *G* and the total cash received from *P*.

The *Gregory* decision,¹⁹⁶ which was held to control the above case, has not been interpreted to exclude all reorganizations which are engineered solely for tax avoidance. Had the Circuit Court of Appeals decision¹⁹⁷ been affirmed without comment, this might have been the result since that court said the readjustment "must be undertaken for reasons germane to the conduct of the venture in hand, not as an ephemeral incident, egregious

193. 32 B.T.A. 238 (1935).

194. 45 Stat. 816 (1928); now La. Act 21 of 1934, § 29(b)(5) [Dart's Stats. (1939) § 8587.29].

195. 45 Stat. 820 (1928); now La. Act 21 of 1934, § 30(a)(8) [Dart's Stats. (1939) § 8587.30].

196. *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

197. *Helvering v. Gregory*, 69 F.(2d) 809 (C.C.A. 2nd, 1934).

to its prosecution." This statement could well have been interpreted thus broadly. However, the Supreme Court limited itself to those situations where the new corporate entity has no function other than that of tax avoidance and is "put to death" when this is accomplished. Presumably a reorganization, though staged for purposes of tax avoidance, would be validated if it resulted in new and permanent entities having a real and germane relationship to the business.¹⁹⁸

When amendments to the Federal Act of 1932 were being drafted, there was as yet no intimation that the use of corporate entities, however ephemeral, was not a proper device to circumvent the statute.¹⁹⁹ Then, too, many reorganizations would still have qualified, despite the rule in the *Gregory* case, because, although launched to save taxes, they nevertheless resulted in corporations which carried on normal corporate functions.²⁰⁰ Obviously, if in a reorganization of this type friendly capital could be induced to hold 21 per centum of the stock, so that immediately thereafter there would not be the requisite 80 per centum control required to force retention of the transferor's basis under Subsection 113(a) (7), a "stepped-up" basis could still be attained.²⁰¹

Advertence to this loophole prompted the draftsmen to lower the percentage of control required in Subsection 113(a) (7) from 80 per centum to 50 per centum in the 1932 Act.²⁰² This was done to discourage the so-called 79 per centum and 21 per centum reorganizations mentioned above. It had this effect, but it also introduced an additional anomaly into the law. This resulted because the 80 per centum definition of control was retained in the definitive subsections of Section 112.²⁰³ As a consequence a corporate exchange was possible which would be taxable to the transferors and yet would not result in a new basis for the property in the hands of the acquiring corporation. An exchange

198. See 2 Paul and Mertens, *op. cit. supra* note 35, at 140, § 17.48; and *id.* (Supp. 1938) at 52, § 17.48.

199. Evelyn F. Gregory, 27 B.T.A. 223 (1932); *Stires Corporation*, 28 B.T.A. 1 (1933).

200. Specifically exempted by the Court. *Gregory v. Helvering*, 293 U.S. 465, 469, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

201. The act provides several methods of qualifying a corporate transfer as a reorganization without necessitating control as defined in the statute. See 45 Stat. 818, § 112(i)(1) (1928); now La. Act 21 of 1934, § 29(g)(1) [Dart's Stats. (1939) § 8587.29].

202. 47 Stat. 199 (1932).

203. 47 Stat. 197, § 112(h) (1932); now La. Act 21 of 1934, § 29(h) [Dart's Stats. (1939) § 8587.29].

based on a reorganization involving less than 80 per centum control would be excluded from the tax-free exceptions in Section 112²⁰⁴ and hence taxable. If the reorganization involved more than 50 per centum control, however, Subsection 113(a)(7) forced retention of the transferor's basis in the hands of the acquiring corporation.²⁰⁵ However, it will not necessarily result that the gain taxed to the transferor will be taxed again in its entirety to the transferee upon subsequent disposition because Subsection 113(a)(7) provides for increasing the transferee's basis by any gain recognized to the transferor.²⁰⁶ The 50 per centum definition of control was continued in both the 1932 and 1934 federal acts and was copied into the Louisiana Act by the legislative draftsmen.²⁰⁷

The purpose of Subsection 113(a)(8),²⁰⁸ the companion subsection of 113(a)(7), has consistently been that of retaining the transferor's basis where a transfer of property is made to a corporation and there is thereafter control, as specified in Subsections 112(b)(5) and 112(h).²⁰⁹ There is no necessity for the presence of reorganization proceedings in order to come within its terms. It is necessary only that the property acquired by a corporation must have been received in exchange for stock and securities.

The provision has received one change since the parenthetical clause previously referred to²¹⁰ was struck out in the 1928 Act. This change was made necessary as a result of a reversal by the Federal Board of Tax Appeals of a ruling of long standing in the Treasury Department. The department had taken the position that even where no new stock was issued, if the requisite control was present, property transferred to a corporation by the stockholders in return simply for an increase in their stock equity

204. 47 Stat. 197, § 112(b)(1)-(5) (1932); now La. Act 21 of 1934, § 29(b)(1)-(5) [Dart's Stats. (1939) § 8587.29].

205. In the Federal Act of 1936 it was thought to avoid this inconsistency by eliminating the fixed percentage altogether. 49 Stat. 1683, § 113(a)(7) (1936), 26 U.S.C.A. § 113 (Supp. 1938). It was restored, however, in 1938, 52 Stat. 574, c. 289, § 807, 26 U.S.C.A. § 113 (Supp. 1938). See 2 Paul and Mertens, *op. cit. supra* note 35, Supp. 1938, at 179, § 18.114.

206. 47 Stat. 199, § 113(a)(7) (1932). "... The basis shall be . . . increased in the amount of gain or decreased in the amount of loss recognized to the transferor. . . ."

207. La. Act 21 of 1934, § 30(a)(7) [Dart's Stats. (1939) § 8587.30].

208. 47 Stat. 200 (1934); La. Act 21 of 1934, § 30(a)(8) [Dart's Stats. (1939) § 8587.30].

209. 48 Stat. 704, 705 (1934); La. Act 21 of 1934, § 29(b)(5), (h) [Dart's Stats. (1939) § 8587.29].

210. *Supra*, p. 241.

would nonetheless take the transferor's basis.²¹¹ An adverse decision²¹² by the Federal Board of Tax Appeals, making possible a "stepped-up" basis by such a procedure, prompted the addition in the 1932 Act of a specific subdivision requiring that the transferor's basis be retained by the corporation acquiring property under such circumstances.²¹³ It is apparent that the same rule should govern as to basis whether a corporation actually issues new shares in return for property or whether there is simply an increase in the value of shares already held resulting from a transfer of property to the corporation.

This subsection, in its amended form in the Federal Act of 1932, was taken over by the Louisiana draftsmen as Subsection 30(a)(8) of the income tax law. The Louisiana Regulation's article²¹⁴ commenting upon this subsection was also copied, in part, from federal regulations.²¹⁵ The article is, in the main, simply a restatement of the provision in the law. However, there is an additional comment which has given rise to considerable confusion in the federal law. The last paragraph in the article reads:

"It should be noted that property may be acquired in connection with a reorganization without the provision of Section 30(a)(7) being applicable, because of the fact that an interest or control of 50 per cent or more does not remain in the same persons. If, however, such a transaction falls within the provisions of this section, the limitations imposed herein upon the basis of such property are applicable."

It is difficult to see how a transfer could fail to be included in Subsection 30(a)(7) because the control thereafter was less than 50 per centum, and yet be covered by Subsection 30(a)(8). This is evidenced by the fact that the latter subsection provides for an adjusted basis only if the exchange was tax-free under Subsection 29(b)(5). To qualify as a tax-free exchange under this provision there must be control immediately after the transfer and that control must consist of ownership of 80 per centum of all stock.²¹⁶ If the transfer meets the "80 per centum" requisite of Subsection 30(a)(8), it will have met the "50 per centum"

211. Senate Finance Committee Report No. 665, 72nd Cong. 1st Sess. (1932) 27.

212. *Rosenbloom Finance Corp.*, 24 B.T.A. 763 (1931).

213. 47 Stat. 200, § 113(a)(8) (B) (1932); now La. Act 21 of 1934, § 30(a)(8) (B) [Dart's Stats. (1939) § 8587.30].

214. La. Rules and Regulations Concerning Income Taxes (1938) art. 192.

215. U.S. Treas. Reg. 77, Art. 599.

216. La. Act 21 of 1934, § 29(h) [Dart's Stats. (1939) § 8587.29]

requisite of Subsection 30(a)(7). A transfer may very well be included in Subsection 30(a)(8) although excluded from Subsection 30(a)(7), but the exclusion will usually arise, not because there is insufficient control, but because the capital readjustment does not qualify as a reorganization within the new limitations placed upon that term in the *Gregory* case²¹⁷ and further illustrated in the *Handbird* case.²¹⁸ This, as a matter of fact, is the gist of this paragraph as it appears in the new Federal Regulations covering the 1936 Act.²¹⁹ The Louisiana Regulations might well follow this federal correction.

VI. JANUARY 1, 1934 AND MARCH 1, 1913—CONCLUSION

Whatever may be the basis determined under the foregoing provisions of Section 30 for property acquired prior to January 1, 1934, that basis will be superseded if the value of the property at January 1, 1934 is greater. Subsection 30(a)(13)²²⁰ provides:

“In the case of property acquired before January 1, 1934, if the basis otherwise determined under this subsection, adjusted as provided in Subsection (b), is less than the fair market value of the property as of January 1, 1934, then the basis for determining gain shall be such fair market value. In determining the fair market value of stock in a corporation, as of January 1, 1934, due regard shall be given to the fair market value of the assets of the corporation as of that date.”

The above provision is a copy of Subsection 113(a)(13) in the Federal Act of 1932²²¹ with the date January 1, 1934 substituted for March 1, 1913. The inclusion of the quoted limitation in the State Act precipitates the question of the extent to which such limitation is necessary or desirable. For both Louisiana and the federal government these dates are the effective dates of the respective acts. Is it necessary, however, that the effective date of the State Act fix a point at which all gains accrued up to that time became converted into capital and immunized from the operation of an income tax? In view of the mountainous propor-

217. *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

218. *Handbird Holding Corporation*, 32 B.T.A. 238 (1935).

219. U.S. Treas. Reg. 94, Art. 113(a)(8)-1. The change in this article cannot be accounted for by the omission from § 113(a)(7) of a fixed percentage control requirement since there must still be 80 per centum control for a transfer to come within § 113(a)(8).

220. La. Act 21 of 1934 [Dart's Stats. (1939) § 8587.1 et seq.].

221. 47 Stat. 201 (1932).

tions of the federal litigation over this distinction,²²² it is not strange that the state draftsmen should attach the same significance to the effective date of the Louisiana Act as March 1, 1913 has in the Federal Act. The importance of the latter date, however, stems not from the fact that it is the effective date of the first act, but that it is the date upon which the Sixteenth Amendment²²³ became operative. The amendment made available for taxation income which up to that date had been exempt under the *Pollock* decision.²²⁴ The constitutional restraints upon the federal government have dictated the interpretation that gains and profits must "arise" after March 1, 1913 to be taxable without apportionment.²²⁵ There is no such constitutional compulsion operative upon the state to distinguish between income arising before and after January 1, 1934. By definition the Louisiana tax is levied simply upon "gains, profits, and income . . . from sales or dealings in property . . . arising out of the ownership, or use, or interest in such property."²²⁶ As a consequence the State is free to tax the whole gain enjoyed by a taxpayer and arising out of the ownership of property without regard to the date on which the property was acquired. If an effective date is to be fixed after which capital gains are deemed to accrue it might be better to substitute March 1, 1913 for January 1, 1934 in this subdivision. This action would eliminate additional valuation problems for the state and make federal computations available for state use. Inasmuch as the federal act was probably copied by Louisiana draftsmen in order to make federal interpretations and appraisals applicable, the substitution would be a step in the direction of implementing such application. At present, if a disposition of property comes within both federal and state income tax laws, a valuation to fix the fair market value at March 1, 1913, January 1, 1934, and date of acquisition may be necessary.²²⁷

222. See, for example, annotations in 6 F.C.A. (1934) 507, par. 353.

223. U.S. Const. Amend. XVI.

224. *Pollock v. Farmers Loan and Trust Co.*, 157 U.S. 429, 15 S.Ct. 673, 39 L.Ed. 759 (1895).

225. *Lynch v. Turrish*, 247 U.S. 221, 38 S.Ct. 537, 62 L.Ed. 1087 (1918); *Merchants Loan and Trust Company v. Smietanka*, 255 U.S. 509, 41 S.Ct. 386, 65 L.Ed. 751 (1921).

226. La. Act 21 of 1934, § 8 [Dart's Stats. (1939) § 8587.8].

227. A full illustration of the methods to be used in arriving at an adjusted basis for property acquired prior to March 1, 1913, is set out in U.S. Treas. Reg. 77, Art. 606. Although in the Louisiana regulations covering adjusted basis generally, the federal regulations have been copied almost verbatim, here the Department omitted all reference to the determination of basis for property acquired prior to January 1, 1934, except in the case of stocks and bonds. La. Rules and Regulations Concerning Income Taxes (1938) Art. 198. No reason has been assigned for this step.

As noted previously,²²⁸ early federal statutory provisions dealing with the subject of tax-free exchanges were largely Congressional attempts to alleviate uncertainty arising in the judicial application of the vexatious rule of severance as the criterion of income. The proliferation of federal statutes on the subject in later years has been in the main an attempt to plug loopholes in the law as they have been brought to light. The initial difficulties stemmed, however, from a federal interpretation applied to a federal constitutional amendment. The states are not bound by this interpretation of how income shall be deemed to arise except in so far as they choose to enact it into law. It would seem that Louisiana, for example, is constitutionally free to adopt, if it chooses, a much broader definition of income. There is no necessity, however, for the state to extend its present definition of income²²⁹ in order to tax, if it chooses, all exchanges, since the state is free to regard the exchange merely as a convenient point at which to tax the gains which have accrued up to that time. By definition the state income tax is levied on the "gains . . . arising out of ownership."²³⁰ Problems of severance need not concern it, unless, as at present, it chooses to follow in federal footsteps. Administrative and equitable considerations may dictate adherence to federal interpretations in the matter of taxing exchanges; such action on the part of the state is clearly elective, however, rather than compelled by fundamental law.

228. *Supra*, pp. 215 et seq.

229. La. Act 21 of 1934, § 8 [Dart's Stats. (1939) § 8587.8].

230. *Ibid.*