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## The Tax-Free Sale of a Business: Reorganizations, Spin-Offs, and Other Feats of Magic under the 1954 Code

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# THE TAX-FREE SALE OF A BUSINESS:

## Reorganizations, Spin-Offs, and Other Feats of Magic

### Under the 1954 Code

By ROBERT O. SWADOS\*

If the Cabots speak only to God, writers on tax reorganization, more often than not, speak only to each other. The complexity of their discourse is understandable, since nowhere in the tax field is there such a forbidding mixture of financial concepts, delicate stockholder-creditor relationships, and technical corporate statutes. The necessity of rigid adherence to the tax provisions on the one hand, and the corporate statutes on the other, require an attention to form in draftsmanship much greater than any branch of the law since the art of the conveyancer became the routine of the junior clerk. Yet the tax reorganization is a useful, practical tool, not only for the large transactions which fill the pages of the Wall Street Journal, but in the acquisition, sale and adjustment of relationships in small business as well. In the face of the complexity of the subject matter, I shall strive mightily to make my analysis understandable at least by a broader audience than the excellent gentlemen who write other papers in this field.

It is a traditional point of departure in discussing tax reorganizations (and a favorite argument of revenue agents) to emphasize that what we are discussing, though the substantial number of pages that follow, is an *exception*. Gain—(we needn't be bothered much with loss in this discussion)—is ordinarily recognized and taxed. Congress has provided an exception where there is a readjustment in the corporate or capital structure, and some or all of the original owners and some or all of the original businesses are continuing in the reorganized corporate arrangement. A transaction which qualifies as a "reorganization" under the federal tax laws is frequently referred to as "tax free" (and will be so here); it is more correct to describe it as a deferment of gain (or loss) until the new shares of stock received in the reorganization are sold.

To illustrate some of the basic principles and tools which we must handle in this field, let us take as an example one which all of us—accountants, lawyers, internal revenue agents, and innocent bystanders—would agree is a "reorganization":

Your client's company (he owns 100 per cent of the single class of capital

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stock) was originally organized in a town in northern Pennsylvania. As sales improved, a new plant was established in Buffalo, N. Y., the administrative offices were moved here, and substantially all the sales and manufacture now take place in the State of New York. The corporation had to qualify to do business in the State of New York, and there is no longer any particular advantage in maintaining the Pennsylvania corporate "domicile," especially in view of some of the irksome local taxes and reporting requirements with which Pennsylvania saddles Pennsylvania corporations.<sup>1</sup> The obvious answer is to shed the Pennsylvania domicile, change the company to a New York corporation, and terminate the Pennsylvania connection. There are various ways in which this could be done, perhaps by organizing a New York corporation and merging it with the Pennsylvania company; you could do it by organizing the New York company, transferring the assets from the Pennsylvania company to the New York corporation, turning in the client's shares of stock in Pennsylvania for the stock in New York, and liquidating the Pennsylvania company. The mechanics of the transaction could be arranged so that the reincorporation in the new state satisfied Type A, Type B, or Type C of the listed authorized types of reorganization in section 368 (a) (1) of the 1954 Internal Revenue Code. But, whatever the mechanics, we have the basic characteristics of a true reorganization: The business is the same, the stockholders are the same, their relative rights and interests are the same. The only adjustment is in the state of incorporation, and there is a business reason for the change.

Yet what I call the modern "alchemy" has made this relatively simple change hardly recognizable, as more complex transactions earn the label "reorganization." I am sure that you all remember the stories of the alchemists of the middle ages, who were engaged in the midnight-after-midnight search for the philosopher's stone that would change the basest metal to pure gold. A tax planner is engaged in a somewhat similar search in his attempt to change the higher-taxed ordinary income into lower-taxed capital gains. In defending itself against this relentless pursuit, Congress, with the aid (or opposition) of the Commissioner of Internal Revenue, has at times had to recognize as non-taxable or tax-deferred corporate adjustments which seemed to depart considerably from our simple reincorporation example. And while the general concept of a reorganization under the tax laws is a continuation of the corporate business in different form, the statute has specific definitions (§ 368) which, in the light of the history of the Internal Revenue Code and the hostility of courts and Commissioner to the use of the reorganization sections to make taxable income "disappear," must be strictly followed as to form, language and substance.

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1. For example, the 3% sales tax adopted March 6, 1956. See Wall Street Journal, March 13, 1956.

## TAX—FREE SALE OF A BUSINESS

Unlike the tax problems of the winner on a television "quiz" program, reorganizations do not arise by accident. They come about as a result of deliberately planned transactions.<sup>2</sup> While the moves prescribed may appear to be somewhat like a game of chess, it is not the ordinary game of chess of which I am reminded, but the strange pursuit of the Men of Mars in one of the old novels of Edgar Rice Burroughs.<sup>3</sup> There, on Mars, the rulers played chess with real men, armed with shield and sword; and if you were a pawn or a knight and made the wrong move, off went your head! Taking what little solace we can from the knowledge that it may not be we, but our clients, who may be decapitated, let us consider the statute.

### THE FACTS

The scene, the *dramatis personae* and the mood are as follows:

Ack Corporation, with net assets of \$100,000, is engaged in the machine tool business and desires to acquire Transit Company, which operates foundries and has gross assets of \$100,000, liabilities of \$50,000.

Ack Corporation has 100 shares outstanding, all held by one stockholder, X. Transit also has 100 shares outstanding, held 70 by stockholder A who is active in the business, 30 by stockholder B, who is a mere investor.

A merger is proposed under which shareholders of both companies would surrender their shares to a new corporation called Rack Corporation, with 150 shares of Rack common stock issued as follows:

To Ack shareholders, 1 for 1, or 100 shares;

To former stockholders of Transit company, 1 share in the new corporation Rack, for each 2 shares of Transit surrendered, or 50 shares.

(The ratio is worked out on the basis of the book value of the assets—the Ack assets have a net value of \$100,000; the net worth of Transit per books being \$50,000; but of course other bases for the ratio of the exchange of stock could be used—earnings, values, appraised values of property, dividends, if any, etc.). Under the ratio of 2 Transit shares for 1 in Rack, stockholder A would receive 35 shares in the reorganized company, stockholder B, 15 shares.

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2. Of course they may be "involuntary," as in SEC or FCC directed exchanges, or in insolvency reorganizations (INT. REV. CODE OF 1954, §§ 371, 1071, 1081). (Unless otherwise indicated, all references in this paper are to the Internal Revenue Code of 1954.).

3. (The "Tarzan" creator).

Included in the assets of Transit which would go to the new company in the merger is the "Surplus Building," situated at the intersection of Boot and Gain Streets, which has been used by Transit in its foundry business, but probably will not be required when the facilities of the merged company are available.<sup>4</sup>

Now, as often happens, A and B do not see eye-to-eye on this transaction. A looks forward to the merger, wishes to remain active in the business, and would not want to sell his stock anyway, since he paid very little for it many years ago and would realize a substantial capital gain with the resulting tax. B has no confidence in the machine tool business, doesn't like X, and would gladly get out, at the sight of an appropriate amount of money for his stock.

How do we arrange the transaction so as to satisfy X, A, B, and the Commissioner of Internal Revenue?

I

WHAT IS A "REORGANIZATION"?

We have discussed the general concept of a "reorganization," but it must be emphasized that only the specific types of reorganization transactions described in section 368 (a) (1) will find ready acceptance by the Treasury. The following are the types of reorganization which are applicable to the problem we are considering at this stage of the discussion:<sup>5</sup>

Type A—A *statutory* merger or consolidation.

Type B—*Stock for stock* — the acquiring corporation (Ack) gets "control" (80%) of the transferring corporation (Transit) by issuing its own stock to the shareholders of the corporation being acquired.

Type C—*Stock for assets*—the acquiring corporation gets substantially all of the properties of the transferring corporation by issuing Ack voting stock to the transferring corporation, for distribution to Transit shareholders.

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4. For the significance of this, see Section VIII of this analysis on "spin-offs."

5. Type F (§ 368 (a) (1) (f) ) is really our Pennsylvania-New York reincorporation. For Type D, which has little application except in corporate separations, see Part VII, *infra*. Because of the application of section 356 of the Code, dealing with "boot," problems similar to those encompassed in a Type E "re-capitalization" are discussed wherever securities are exchanged in our reorganization; but out of self-limitation, this paper does not deal with recapitalizations specifically. (See Friedman & Silbert, *Recapitalizations*, N. Y. U. 13TH INST. ON FED. TAX 533).

Types B and C are sometimes called non-statutory or "practical" mergers. Despite the voluminous reports on adoption of the 1954 Code, the Treasury's work of interpretation goes slowly, and the "final" Treasury Regulations have just emerged.<sup>6</sup> These regulations insist that a transaction must fit "specifically" within one of the definitions in section 368 (a) (1) (U. S. Treas. Reg. § 1.368-1 (c) ) to qualify as a reorganization. Decisions under the 1939 Code and the history of the reorganization sections of the taxing acts suggest, however, that transactions which are the same in substance or have the same "net effect" as those specifically defined may qualify.<sup>7</sup> (See Merritt, *Tax Free Corporate Acquisitions—The Law and the Proposed Regulations*, 53 MICH. L. REV. 914 (1955).

## II

### WHY A "REORGANIZATION"?

We have already begun to consider at least two purposes of the reorganization transaction — (1) to change the state of incorporation so as to avoid onerous local taxes or obtain the advantage of the corporate statutes of another state which are more liberal; (2) to permit purchase of the corporate business without subjecting the selling shareholders to substantial dividend or capital gains taxes. Of course there other purposes, such as (a) to rearrange the capital and debt structure of a corporation in financial difficulties so as to give creditors equity stock in exchange for their debt claims and subordinate common stockholders; (b) to combine corporate businesses to promote sales, provide diversification of products, increase financing possibilities; (c) to separate corporate businesses so as to reduce liability of profitable for unprofitable divisions, reduce state income taxes, facilitate ultimate sale of part of the corporate business and divide the continuing business among stockholders. There are also possible tax "side effects" of reorganizations which should not be—but sometimes are — a principal motivation:

- (1) in corporate combinations: continuation of high basis for assets acquired, carryovers of losses and credits facilitated under section 381 (except in Type D reorganizations); and spin-offs facilitated (by acquiring an active trade or business);
- (2) in corporate separations: the additional \$25,000 surtax exemption, reduction

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6. The Treasury issued its "final" regulations on corporate distributions and adjustments (T.D. 6152, 20 F. R. 8875, Dec. 3, 1955; I. R. B. 1955-50, Dec. 12, 1955; 1956 U. S. CODE CONG. & AD. NEWS 143 ff.) almost one year after notice of the proposed regulations was filed with the Federal Register. (19 F. R. 8237, Dec. 11, 1954).

7. The Treasury at times urges this itself. See, e. g., *Pebble Springs Distilling Co.*, 23 T. C. 196 (1954).

in rate of tax, and the additional \$60,000 exemption from the tax on unreasonable accumulation of earnings (\$60,000 exemption from section 531 (old § 102) ).

If these tax side effects are a principal motivation, the Commissioner is not without weapons to defeat the reorganization. In addition to the possibility of invoking the "business purpose" rule (see Part III-C), he has the power to allocate income and deductions under section 482 (old § 45), the power to place on the taxpayer the burden of supporting the argument that the separation does not have as a principal business purpose the availability of the additional surtax or accumulations exemption (section 1551, old § 15 (c) ), and, finally, at least where the tax benefit is acquired from the "selling" corporation, the possibility of charging that the tax avoidance purpose requires the disallowance of the deduction or the high basis (section 269, old § 129).

### III

#### THE RULES OF THE GAME

In analyzing any reorganization problem, there are certain fundamental methods of approach and certain not-so-fundamental provisions of the Code and court interpretations which cut across all of the types of reorganization transactions.

A. First of all, it is important to distinguish between

- (1) the tax consequences to the corporations involved in the "reorganization," and
- (2) the tax effect on the *stockholders* who may receive stock or securities or other property as a result of the reorganization.<sup>8</sup>

B. As to property *received by the shareholders*, distinguish between

- (1) voting common stock which may be received tax free;
- (2) cash, which always has a tax consequence, either as a capital gain, reduction in basis or as a dividend (ordinary income);

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8. For example, we look to see whether the transaction between the corporations is a "reorganization" under section 368 (a) (1), tax free under section 361; then to section 354 to see the tax consequence of the exchange of shares and other property by the shareholders.

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- (3) "securities" (e.g., long-term bonds) which may be exchanged tax free for other "securities," but in most reorganization transactions under the new Code, where no securities are surrendered, may also be treated as the equivalent of cash—producing capital gain or ordinary income (§ 354 (a) (2); § 356 (d) (2) (c) );
- (4) assumption of a liability, which in some reorganizations is ignored (§ 368 (a) (1) (c) ), but in a Type D reorganization where the liability exceeds basis is treated as the equivalent of cash (§ 357 (c) ); and finally
- (5) preferred stock, the receipt of which, like voting common stock, may in an "A" type reorganization be treated as non-taxable and produce no immediate tax, but may give rise to ordinary income on sale or redemption (see § 306).

Where cash, property, or securities are received by a shareholder in addition to the shares of stock which may be received tax free, the jargon calls it "boot".

C. The following "judge-made" rules, while not specifically dealt with in the Code or committee reports, are still important factors in analyzing any reorganization problem:

1. The house that Gregory built (*Gregory v. Helvering*, 293 U. S. 465 (1935) );<sup>9</sup> the transaction must have a *bona fide corporate business purpose* (see U. S. Treas. Reg. § 1.368-1 (c) ).
2. The "squeeze-box" principle—"step transactions": the Commissioner and the courts may consider and telescope a series of transactions (such as a spin-off, followed by a liquidation) as part of one plan, if close together in time, or if legally or logically dependent upon one another, in determining whether the transactions qualify or do not qualify for non-recognition.

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9. Mrs. Gregory caused her holding company, which owned all of the shares of X corporation, to transfer the X shares to Y company, and issue the Y shares to her. Six days later, she liquidated Y company, and reported the difference between the value of the X shares received on the liquidation and her allocated basis as capital gain. The result: for Mrs. Gregory, under the Supreme Court's decision, instead of capital gain a substantial dividend tax, which her counsel conceded the transactions were intended to avoid; for taxpayers generally, the "spin-off" route was blocked for 15 years. (See Part VIII, *infra*).



3. The umbilical cord, or "*continuity of interest*" requirement — the original owners of the equity must continue (to a variable extent, depending upon the type of reorganization) as owners of the equity in the reorganized corporate enterprise.<sup>10</sup> (This has been modified to some extent in the 1954 Code — see §§ 368 (a) (1) (D) and 355 (a) (2) (A) ).

D. Certain *mechanics* must be followed:

- (1) There must be a "plan" of reorganization<sup>11</sup> which should, but need not, be in writing (*Walter S. Heller*, 2 T. C. 371 (1943); *James G. Murrin*, 24 T. C.—No. 57 (1955) ), and under the regulations must be adopted by the board of directors of each corporation involved (U. S. Treas. Reg. § 1.368-3);
- (2) the stock or securities received in an exchange which is a step in the reorganization must be those issued by "a party to the reorganization" (§ 354 (a) (1) ).<sup>12</sup>

E. A key word is "*control*", defined in § 368 c).

"Control" which must be acquired in a Type B, or which must exist in a Type D reorganization, means 80% of the total combined voting power of all classes of voting stock plus 80% of the total number of all other shares. That does not mean that you need to acquire 80% of *each class of voting stock*; but if, as under the law of Illinois,<sup>13</sup> preferred shares have voting rights, the votes of the preferred must be added to the votes of the common to determine whether the requisite 80% has been obtained.

F. It should also be remembered that the reorganization avenue is not a one-way street, although the Treasury may sometimes seem able to change the

10. The Treasury purports to require a continuity of the "business enterprise" (assets) as well as a continuity of the business owners (U. S. Treas. Reg. § 1.368-1 (b) ). Compare *Scofield v. San Antonio Transit Co.*, 219 F. 2d 149 (5th Cir. 1954), *cert. denied* 350 U. S. 823 (1955), with *Reilly Oil Co. v. Commissioner*, 189 F. 2d 382 (5th Cir. 1951) and *Becher*, 22 T. C. 932 (1954). The new regulations recognize, however, that section 338 (a) (1) (D) creates an exception to the continuity-of-persons requirement, and that the rule may be satisfied if the participants in the reorganized enterprise were "indirectly" owners prior to the reorganization.

11. Exception: Spin-offs, etc., under section 355.

12. In a Type C reorganization the securities issued by the parent having 80% or more control of the acquiring corporation may be used: § 368 (b), intended to abrogate or modify the *Groman* (302 U. S. 82 (1937) and *Bashford* (302 U. S. 454 (1938) ) cases; § 368 (a) (1) (C).

13. *People v. Emmerson*, 302 Ill. 300, 134 N. E. 707 (1922).

color of the signals at will. It may be to the advantage of the "revenueur" to assert that what appears to be a sale is in fact a tax-free reorganization; and he has done so effectively, to deny an operating loss deduction on the sale of assets, to subject a cash distribution on an exchange to dividend tax instead of capital gain, and to deny a "stepped-up" basis to an acquiring corporation.<sup>14</sup>

G. It will usually be possible to obtain the written views of the Treasury in advance. But it may come as something of a shock to the practitioner who is not inured to the curious trade practices of the tax field that even a solemn specific ruling by the United States Treasury Department, Internal Revenue Service, Tax Rulings Division, that a proposed transaction is a tax-free reorganization may be little more than a temporary precedent. To the anxious practitioner who is concerned about the foundation of his proposed corporate acquisition, the ruling may make the foundation look secure; but quicksand it may nevertheless turn out to be. Unless the statute of limitations is applicable, the Commissioner is not prevented from changing his views nine years later, taxing the very transaction and the very taxpayer involved in the ruling on a basis the same as or different from that considered in the precious letter in tax counsel's files.<sup>15</sup>

#### IV

#### MERGER

#### (TYPE A)

The first type of reorganization set out in § 368 (a) (1), and the first type approved by Congress as well, historically, is the statutory merger or consolidation. In New York, Ack and Transit could use section 85 of the Stock Corporation Law (the "merger" statute in New York) or section 86, the "consolidation" statute. Section 85 is really a liquidation of a subsidiary. Section 86 is what is known in most states as a "merger".<sup>16</sup>

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14. *Pebble Springs Distilling Co.*, 23 T. C. No. 29 (Oct. 29, 1955); *Liddon v. Commissioner*,—F. 2d— (6th Cir. 1956), P-H 1956 FED. TAX SERV. ¶72429; *Becher v. Commissioner*, 22 T. C. No. 112 (1954), *aff'd* 221 F. 2d 252 (2d Cir. 1955); (P-H 1955 FED. TAX SERV. ¶72574; *Transport Products Corp.*, 25 T. C. No. 97 (Jan. 24, 1956); *Stockton Harbor Industrial Co. vs. Commissioner*, 216 F. 2d 638 (9th Cir. 1954)

15. *Avco Manufacturing Corp.*, 25 T. C. No. 111 (1956). Of course, if the initial case reaches audit, a closing agreement as to liability (§ 7121) may be possible, or the modified estoppel of §§ 1311 ff. (1939 CODE § 3801) may operate to repair some of the damage.

16.- Compare DEL. CORPORATION LAW § 251 ("consolidation or merger"), § 253 ("merger of parent corporation and wholly owned subsidiary").

A. *Tax consequences of the statutory merger or consolidation.*

- (1) Whether the shares in Rack are distributed first to Transit and then distributed directly by Rack to the former shareholders of Transit, no gain or loss would be recognized to any of the corporations (§ 361 (a) ).
- (2) Under section 354 (a) no gain or loss would be recognized to any of the shareholders of Ack Corporation or of Transit Company. We may assume that all of the assets of both Transit and Ack are transferred to Rack and all of the shares of stock in Rack received are distributed to the shareholders of each of the original companies, since this follows as a matter of law under sections 85 and 86 of the Stock Corporation Law.<sup>17</sup>
- (3) The consolidated company would have the same basis with respect to assets received as the companies participating in the merger, and the shareholders would substitute for the Rack shares received their respective cost bases for shares surrendered in exchange.<sup>18</sup>

B. *Suppose stockholder B — the investor — wants out with cash or other "boot" — presumably \$15,000?*

That would not destroy the tax-free character of the reorganization as to stockholder A, since A's continuity of interest (70% in the Transit Company assets forming part of the reorganized company) is probably sufficient.<sup>19</sup> But B will owe a capital gains tax on the difference between his cost and the cash received.

C. *Could stockholder B receive, tax-free "securities" (such as long-term bonds) instead of voting stock in the reorganized company? No.* Under sections 354 (a) (2) and 356 (d), since stockholder B would be surrendering no "securities", the principal amount of the bonds received by him would be treated as cash received and subject him to capital gains tax. In *Bazley v. Commissioner*, 331 U. S. 737 (1947) the Supreme Court held on the facts there presented that an exchange of stock for new stock and long-term debentures (literally a recapitaliz-

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17. Subdivision (9) of section 86 requires the certificate of consolidation to specify "the manner of converting the shares of each of the constituent corporations . . . into shares or other securities of the consolidated corporation"; and section 89 states that: "upon the filing of such certificate of consolidation . . . all the rights, privileges, franchises and interests of each of the constituent corporations, and all the property, real, personal and mixed . . . [etc.] . . . shall be taken and deemed to be transferred to and vested in such consolidated corporation, without further act or deed". Thus a partial "reorganization", or Type D, cannot be accomplished through sections 85 or 86 of the New York Stock Corporation Law.

18. Sections 363, 358.

19. *Reilly Oil Co. v. Commissioner*, 189 F. 2d 382 (5th Cir. 1951) —69%;—*James G. Murrin*, 24 T. C. No. 57 (1955)—72%.

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ation type of reorganization) resulted in the taxation of the value of the debentures to the receiving stockholder. Section 356 (d) takes the result in the *Bazley* case and makes it a general rule of law.

D. *Could stockholders A and B be given part stock and part cash or part stock and part securities? Yes*, but capital gain would be recognized to the extent of the cash or securities received ("boot"). Also, watch this further risk in section 356: If Transit Company has accumulated earnings and profits, and the distribution of cash or securities is *pro rata* or otherwise "has the effect" of the distribution of a dividend, the cash or securities may be ordinary income to stockholders A and B (§ 356 (a) (2); *Commissioner v. Bedford's Estate*, 325 U. S. 283 (1945)).

Would it make any difference if A and B were given preferred stock in Rack in addition to the voting stock? Here the danger would be in section 306—the "hot" preferred stock section, which makes any preferred stock dividend potential ordinary income on a subsequent sale or redemption. If the preferred stock is distributed *pro rata* to the former shareholders of Transit, the distribution may be a transaction substantially equivalent to a dividend, and, on subsequent sale or redemption, under section 306 (c) (1) (B), both A and B may be taxed on the amount received as ordinary income to the extent it would have been a dividend if received in cash on the original issuance of the preferred stock (§ 306 (a) (1) (A)-ii).

E. *Advantages of merger.* As we shall see, the other avenues of reorganization generally restrict the means of "purchase" to voting common stock in the acquiring or successor corporation. A merger permits more flexibility in the choice of distribution to the "selling" shareholders—voting stock, preferred stock, cash or securities — and strengthens the possible use of carryovers under Section 381, and the continuance of high basis of assets on the books of the transferor. Moreover, a merger may be possible (subject to the requirements of corporate law and the "continuity of interest" rule) without obtaining 80% control of the transferor company. For example, New York Stock Corporation Law section 86 requires only 2/3 of the shareholders in the selling corporation to vote in favor of the merger.

F. *In that case, why not always use a merger?*

Some of the disadvantages and difficulties:

1. Some states have no merger statutes; some states (like Minnesota<sup>20</sup>)

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20. At least until 1951 (MINN. REV. STAT., § 301.41, as amended by L. 1951, c. 98, § 8).

do not permit merger of domestic and "foreign" (out-of-state) corporations. Even section 91 of the New York Stock Corporation Law permits the consolidation of a domestic with a foreign stock corporation only "if the laws of such other state or states so permit."

2. The New York merger statute (Stock Corporation Law, § 85), which is the simplest procedure, would require Ack first to acquire 95% ownership of Transit, and requires that the transferring company be "authorized to engage in business similar or incidental" to the acquiring corporation (§ 85 (1) ).

3. While the consolidation statute, section 86 of the New York Stock Corporation Law, permits a consolidation on the vote of the holders of  $\frac{2}{3}$  of the voting shares in each corporation, under both consolidation (§ 87) and merger (§ 85-7) dissenting stockholders have the power to demand an appraisal and payment for their shares; and if stockholder B did not agree with the 2-to-1 ratio proposed, or otherwise refused to go along in the plan of reorganization, he could subject the consolidated company and Transit to a substantial cash liability.

G. *Immediate sale.* Could stockholders A and B forthwith sell the shares in Rack received on the exchange? Not if it could be demonstrated that their sale was contemplated as part of, or necessary to, the original plan. Under the "step transaction" rule, if the sale were part of the plan, the tax-free character of the reorganization might be destroyed, resulting in tax to the Ack stockholders as well.<sup>21</sup>

V

TYPE B — STOCK FOR STOCK

Suppose that a statutory merger or consolidation is not practicable. Ack Corporation might attempt an acquisition for voting stock under subdivision B of Section 368 (a) (1).

A. *The requisites are:*

- (1) "*Solely*" voting stock, neither cash nor preferred stock nor securities, may be used in the acquisition.

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21. See *Ralph M. Heintz*, 25 T. C. No. 21 (Oct. 27, 1955), in which an alleged commitment by the acquiring corporation to facilitate resale of the preferred stock received on the exchange was used successfully by Jack & Heintz to obtain capital gains treatment and to defeat the Treasury's claim that the use of a statutory merger resulted in a tax-free reorganization, plus dividend "boot".

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- (2) Ack Corporation must end up with "control" (see III-E above) — 80% of the voting stock of Transit, immediately after the acquisition.

You can see the immediate difficulty. Stockholder B, the mere investor, may object and demand cash, bonds or preferred; since he owns 30% of Transit, he blocks the reorganization.

B. Could stockholder B be given his 30% interest in Transit partly in stock, to give the 80% control, the balance in cash? It is questionable if this could be done in "one transaction" under the regulations (U. S. Treas. Reg. § 1.368-2 (c) ), because the cash and stock consideration flowing to stockholder B are concurrent.<sup>22</sup>

C. If A owned 80%, could you give Ack common stock to A and cash to B? While the regulations do not make this distinction, the continuity of interest is probably sufficient and the transaction may qualify as a Type B reorganization. It is preferable to make an individual deal with B, separate in time and plan from the reorganization (cf. *William Hewitt*, 19 B.T.A. 771 (1930) ). Of course this would raise a practical as well as a legal problem. Some duty might rest upon management to be fair and make the same offer available to all shareholders. Suppose Transit had numerous stockholders. How does one make sure that the right number of stockholders agree to take stock?

D. "*Creeping*" control. Suppose Ack Corporation bought B's Transit stock for cash in 1955 and acquired A's remaining 70% for Ack's voting common stock in 1956? The 1954 Code intended to provide some relief here, contrary to *Pulfer*, 43 B.T.A. 677 (1941) which held that you have to acquire the 80% control for stock at one time in one transaction. The legislative history indicates that clause B was amended in the 1954 Code to remove any "doubt as to whether the existing statute permits such an acquisition tax free when the acquiring corporation already owns some of the voting stock of the other corporation", even if the acquisition is "in a single transaction or in a series of transactions taking

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22. Thus unlike a Type A merger, the use of "boot" (whether cash, preferred stock or other property) subjects the gain in the entire amount realized—boot plus stock—to tax. In *Hubert E. Howard*, 24 T. C. No. 90 (July 9, 1955) (discussed in 3 J. TAXATION 363 (1955) ), the court held, under the 1939 Code, that acquisition of 80.19% of the transferring corporation's stock for voting stock, at the same time that the balance of the stock was acquired for cash, apparently from unrelated stockholders, was not an exchange "solely" of voting stock for 80% control and did not qualify as a reorganization. It will be observed, however, that in the *Howard* case the principal executive of the transferring company acted as agent for all of the stockholders, both those who received only stock and those who received only cash, and that in at least one case one of the stockholders (a charitable institution) received both cash and stock. See also Rev. Rul. 396, 1954-2 CUM. BULL. 147.

place over a relatively short period of time such as 12 months".<sup>23</sup> However, the Treasury takes the position that if (applying the step transaction rule) the cash and stock acquisition can be treated as "one transaction," the plan is disqualified. (U. S. Treas. Reg. § 1.368-2 (c) ). The regulation appears to be inconsistent with the Committee Reports; but the example in the Committee Report (adopted in the regulations) does separate the cash and stock acquisitions by 16 years! Compare 68 HARV. L. REV. 416 (1955); Darrell, *Corporate Organizations and Reorganizations Under the Internal Revenue Code of 1954*, 32 TAXES 1013 (1954).<sup>24</sup>

E. *Corporate procedures.* The regulations require each corporation to adopt the plan of reorganization,<sup>25</sup> even though only the stockholders of Transit are involved. Presumably this means resolutions of the Board of Directors of each corporation, and action at a stockholders' meeting of Ack would not be required. If Ack has treasury stock (stock which was originally issued and repurchased or surrendered) sufficient to carry out the transaction with A and B, that treasury stock may of course be used. If there is no "treasury" stock, as I have defined it, but merely authorized and unissued shares, care must be taken to be sure that the unissued stock is not subject to preemptive rights. Under section 39 of the New York Stock Corporation Law, subdivision 4, the shares would not be subject to preemptive rights if they "are issued or optioned by the board of directors to effect a merger or consolidation, or for a consideration other than cash". If there is no treasury stock, or no authorized but unissued shares, Ack's certificate of incorporation must be amended to increase its capital stock, requiring the consent of a majority of the shareholders.<sup>26</sup> (That would be no problem here, since X is the sole stockholder in Ack Corporation). Should a merger be desired after Ack gains the requisite 80% control of Transit, section 85 or section 86 of the Stock Corporation Law and section 332 of the Code must be followed to effect a liquidation of Transit, now a subsidiary.<sup>27</sup>

23. S. REP. No. 1622, 83rd Cong., 2d Sess., 273 (1954); Prentice-Hall reprint, p. 24314.

24. See the further discussion in part VI-C, *infra*, of buying out minority interests in order to qualify the transaction as a reorganization.

25. U. S. Treas. Reg. § 1.368-3.

26. N. Y. STOCK CORPORATION LAW § 37; DEL. CORPORATION LAW § 242.

27. In that liquidation, since the subsidiary was acquired for stock in a non-taxable reorganization, section 334 (b) (2) (the *Kimbell-Diamond* rule, permitting the use of a new basis for the assets acquired) will not apply.

VI

TYPE C — STOCK FOR ASSETS

Suppose that Transit Company has contingent liabilities, or for other reasons Ack Corporation does not wish to acquire Transit stock, with the resulting inheritance of Transit's corporate troubles. The Type C reorganization may be indicated.

A. The general rule is that Transit must transfer "*substantially all*" of its properties, in exchange *solely* for Ack's *voting stock*. This plan has certain possible advantages over Type B:

1. Could Ack Corporation, in addition to giving voting stock, assume or take subject to Transit's \$50,000 liabilities? *Yes* — if the *only* other consideration is voting stock. But the Commissioner may argue in some cases that the size of the liability assumed, its ratio to total assets transferred, means the transaction is really a purchase, not a reorganization (U. S. Treas. Reg. § 1.362-2(d) (1) ).

2. Ack Corporation could give Transit stock for 80% (by market value) of its assets, cash for the balance (§ 368 (a) (2) (B) ), and the cash then could be distributed to stockholder B, with A receiving all stock, tax free (§ 354 (a) ).

3. *However*, Ack Corporation could not give cash *and* assume Transit's liabilities, since "other property" may be given for no more than 20% of the value of Transit's gross assets, and for this purpose you count as "other property" liabilities assumed or to which property acquired is subject. (§ 368 (a) (2) (B) ). No gain is realized by the Transit Corporation if it distributes the cash (§ 361 (b) ).<sup>28</sup>

4. Ack Corporation may under the new Code transfer a part or all of the assets received to a new subsidiary (§ 368 (a) (2) (C) ).

5. If Ack were in fact owned by another corporation having 80% control, Ack could use the parent's voting stock instead of Ack using its own (§ 368 (a) (1) (C) ) — but, under the Treasury's interpretation, *not* part stock of the parent and part subsidiary stock (U. S. Treas. Reg. § 1.368-2 (d) (1) ).

B. *Corporate procedures*. Here, as in the case of the stock-for-stock reorganization, corporate law would probably require appropriate resolutions of the board

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28. Note that if Transit's liabilities were only \$10,000, Ack Corporation could give stock for the properties, assume the debts, and also give cash up to \$10,000 (U. S. Treas. Reg. § 1.368-2 (d) (3) ).



of directors of Ack; but since the transaction may for non-tax purposes be a sale of Transit's assets, consent of two thirds of Transit's stockholders would be required; and objecting stockholders have the right to demand appraisal of and payment for their shares (N. Y. STOCK CORPORATION LAW §§ 20, 21). But since the stock of Ack would now be held in Transit, liquidation or dissolution proceedings should then follow to hand the Ack shares over to Transit shareholders, under New York Stock Corporation Law section 105, and New York General Corporation Law section 29, the exchange of Transit for Ack shares being tax free under section 354 (a) of the Code.<sup>29</sup>

C. *Buying out B first; disposition of minority interests.*

Suppose B objects? His right of appraisal as the owner of 30% of the Transit stock may as a practical matter block the reorganization. If he owned more than one-third of the outstanding shares, he would have the legal power to do so.<sup>30</sup> Can A arrange the redemption of B's shares first, then consummate the reorganization? If there is no gap in time, there is some danger that the Commissioner would treat the consideration to B as flowing from Ack corporation, and the exchange would not be "solely" for voting stock.

Of the many areas in the reorganization field where neither the regulations nor the decisions provide adequate clarification, one which is of great practical importance is the extent and methods by which minority interests can be eliminated as preliminary to or in connection with the reorganization plan. The decisions tell us that "it is almost a universal experience that some nonassenting stock must be acquired otherwise than through the mechanics of the consolidation plan," and that such preliminary acquisition need not destroy the tax-free character of the reorganization.<sup>31</sup> Indeed, section 302 of the 1954 Code, with its mathematical criteria for distinguishing between a redemption equivalent to a dividend and a buy-out which results in capital gain, would seem to facilitate these preliminary transactions.<sup>32</sup> Yet in the stock-for-stock (Type B) reorganization, cases such as *Hubert E. Howard*<sup>33</sup> suggests that even if A held 80% of the stock of

29. Suppose, because of the use of cash or other boot that comes close to the 20% limit, the transaction between Transit and Ack is ultimately determined to be taxable. While the result may seem far fetched, there is a danger that the profit on the sale may be taxed twice—to Transit Company on the exchange and to Transit shareholders on the liquidation. Caution may therefore require the adoption of a "plan of liquidation" under Code section 337 before the reorganization agreement is executed.

30. N. Y. STOCK CORPORATION LAW §§ 20, 21.

31. *Miller v. Commissioner*, 84 F. 2d 415, 419 (6th Cir. 1936), a Type B reorganization, decided before *Southwest Consolidated Corp.*, 315 U. S. 194 (1941), discussed *infra*.

32. Section 302 (b) (3), complete termination of interest, and § 302 (b) (2)—the 80%-50% rule on "disproportionate" redemptions.

33. See note 22 *supra*.

Transit Co. and B only 20% a payment of cash to B concurrently with the issuance of Ack stock to A would disqualify the transaction, and even A's stock would be subjected to capital gains tax. It is submitted that the *Howard* case and cases like it reach an undesirable result. Certainly if A receives only stock, B will receive only cash, if the continuity of interest is 80% or more; if the other requisites of the corporate reorganization, whether Type B or Type C, are satisfied, the transaction should not be disqualified for reorganization treatment. The Treasury is usually better off from the point of view of taxation of the seller (since it gets the tax on B's sale) than it would be if nothing but stock reached Transit's shareholders. Any unfair advantage to the buyer in the form of the use by Ack of a high basis on Transit's books may be mitigated by the Treasury through the use of its power against acquisitions to avoid income tax under section 269. The partial relaxation of the "solely for voting stock" requirement in the Type C reorganization (§ 368 (a) (1) (C) ) recognizes this, but does not go far enough, since the case will be rare in which the liabilities assumed will be less than 20% of the gross assets transferred.<sup>34</sup>

The problem may be posed because the controlling shareholders in the acquiring corporation are unwilling to dilute their control, and therefore refuse to give a sufficient number of shares directly or indirectly to all shareholders in Transit. If a *pro rata* delivery of stock is accompanied by a *pro rata* payment of cash to Transit, thereafter distributed to Transit shareholders, the transaction of course fails to qualify as a reorganization, except where the statutory merger of consolidation section (Type A) can be used. If the use of part cash and part stock is possible in a statutory "merger"<sup>35</sup> it should be possible even if a practical merger authorized by subparagraphs B or C of section 368 (a) (1) is effected. If both transferring and acquiring corporations are closely held the distinction between a statutory and a practical merger becomes insignificant.<sup>36</sup>

Does it make any difference if the consideration for the surrender of B's shares comes from someone other than Ack Corporation? In *Stockton Harbor Industrial Co. v. Commissioner*, 216 F. 2d 638 (9th Cir. 1954), the court held (in a stock-for-assets transaction under section 112 (g) (1) (C) of the 1939 Code) that a loan of \$20,000 to the selling company by a stockholder of the buying company which was used for the purpose of enabling the selling company to pay certain of its fixed obligations "was not a part of what the new corporation paid for the assets of its predecessor", and the transaction was a tax-free reorganization.

34. Section 368 (a) (2) (B).

35. See discussion in paragraphs B and C of Part IV, *supra*.

36. Compare the distinction between publicly held and closely held corporations suggested in the American Law Institute Income Tax Project (see Surrey & Warren, *The Income Tax Project of the American Law Institute*, 66 HARV. L. REV. 1161, 1180 (1953) and section 359 of the bill which ultimately became the Internal Revenue Code of 1954, H. R. 8300, as it passed the House.

Here it was the taxpayer who asserted that the transaction was taxable and the Commissioner who argued successfully that the loan did not take the exchange outside of the tax-free reorganization definition.

In the same way, in *Transport Products Corporation*, 25 T. C. No. 97 (Jan. 24, 1956), the court held that an obligation of shareholders of the acquiring corporation to purchase from the transferring corporation or its shareholders certain shares in the reorganized company, if demanded by the transferor corporation, did not disqualify the transaction as a non-taxable reorganization, and as the government urged, the taxpayer was not entitled to a higher basis for the assets acquired.

If the dissenting or departing shareholders are first paid off by Transit out of its own cash balances, this is probably unobjectionable, so long as the continuity-of-interest rule is satisfied. In *Westfir Lumber Co.*, 7 T. C. 1014 (1946), the court held that a transaction was still "solely for voting stock" and still a non-taxable reorganization, even though the acquiring corporation had a dissenting bondholder in the old company paid off in cash, where the evidence indicated that the sum was paid from the account of the transferring corporation and the court considered that the acquiring company had no cash.

Suppose that Transit at the date of the reorganization negotiation has an insufficient cash amount or current assets for the redemption of B's stock? It will be recalled that subsection (C) of section 368 (a) (1) permits, in a stock-for-assets transaction, the assumption of liabilities of the transferor. Could Transit borrow enough money to pay off B and then transfer its assets to Ack, with Ack assuming the Transit liabilities, including the newly-incurred loan, and issuing its stock to Transit for ultimate distribution to A as the sole remaining shareholder? *Helvering v. Southwest Consolidated Corp.*, 315 U. S. 194 (1942), gives considerable difficulty. There, in the course of the reorganization of an insolvent company, bondholders who refused to go along with the new corporation, holding obligations in the face amount of \$440,000, were paid off in cash while the balance of the security holders received solely voting stock. The court held<sup>37</sup> that the cash spoiled the tax-free character of the reorganization:

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37. 315 U. S. 194, 199. This point was not necessary to the holding of the case, since the court went on to decide—and this is the point upon which the case is usually cited—that the issuance of warrants by the acquiring corporation, in addition to voting stock, was sufficient in itself to disqualify the transaction as a tax-free reorganization. On the assumption of liability issue, see the following cases in which the assumption did not disqualify the transaction as a reorganization: *Roosevelt Hotel Co.*, 13 T. C. 399 (1949); *Hoboken Land & Improvement Co. v. Commissioner*, 138 F. 2d 104 (3d Cir. 1943); *New Jersey Mortgage and Title Co.*, 3 T. C. 1277 (1944); Cf. *Central Kansas Telephone Co. v. Commissioner*, 141 F. 2d 213 (10th Cir. 1944), where borrowing by the new company to pay off nondepositing bondholders was held to disqualify the reorganization, on the ground that "while the obligation to pay the cash had its origin in obligations of the old company to the nondepositing bondholders, its nature and amount were determined and fixed in the reorganization . . ."

"That cash was raised during the reorganization on a loan from a bank. Since that loan was assumed by respondent, it is argued that the requirement of Clause B [now C], as amended in 1939, was satisfied. But in substance the transaction was precisely the same as if respondent had paid cash plus voting stock for the properties."

Decisions such as *Stockton* and *Transport Products* (pp. 133 and 134), *supra* may soften the influence of the *Southwest Consolidated* case, but at most provide a very flexible criterion in framing the question in terms of whether the loan effected for the purpose of buying out the minority was a "pre-existing obligation . . . determined and fixed prior to the reorganization", or a liability "determined and fixed in the reorganization". The distinction between the case where the amount used to pay off the minority shareholders comes from the transferor corporation in the form of cash rather than from the acquiring corporation in the form of an offset or liability on the transferor's balance sheet is not a very satisfactory basis of decision. The suggestion in the *Transport Products* and *Stockton Harbor* cases that the transaction will not be disqualified if the cash is paid or liability incurred by controlling stockholders of the acquiring corporation, instead of by the acquiring corporation itself, seems highly artificial, especially where the stock in the acquiring corporation is closely held. The question should rather be decided upon the basis of whether there is sufficient continuity of interest with respect to the assets transferred to the acquiring corporation, and in the interests of the remaining stockholders in the old who become stockholders in the new corporation. The major purpose of the limitation of the type of consideration in Type B and Type C reorganizations to voting stock was to insure that continuity of interest. If that question is answered satisfactorily, and it can be established that not part of the cash paid or the liability assumed to buy out the minority inured to the benefit of the stockholders remaining in the corporate venture, a tax-free reorganization should be permitted.

The Treasury may have opened the windows to let in some light or the doors to invite some trouble, as the case may be, in Revenue Ruling 55-440 (Internal Revenue Bulletin July 5, 1955, p. 7). There the Internal Revenue Service approved as a non-taxable organization within section 368 (a) (1) (B) of the 1954 Code a series of transactions in which (a) the selling corporation redeemed its voting preferred stock by giving thirty days' notice of intention to redeem, and (b) the buying corporation acquired all of the outstanding common stock of the selling company in exchange for its own voting common stock. The Service held the transactions to be non-taxable even though all of the preferred stock had not been fully redeemed; some was outstanding not only at the time the contract for the exchange of voting shares was entered into, but at the time it was consummated. The ruling did not consider or refer to the argument that the cash used to pay off

the preferred shareholders might be deemed to have come ultimately from the acquiring corporation; nor did the ruling indicate whether the cash for the acquisition of the preferred was derived from a loan. The precise decision was that since the notice of redemption terminated the rights of the holders of preferred as *stockholders*, the preferred stock would be disregarded in determining whether the acquiring corporation was in control (owning 80% of all outstanding shares) for the purposes of section 368 (c) of the Code. But RR 55-440 certainly assumes that the redemption of the preferred stock and acquisition of the common in these circumstances will not be considered a "one transaction" so as to disqualify the exchange of voting stock as a non-taxable reorganization, and thus has the desirable effect of facilitating the elimination of minority interests in stock-for-stock and stock-for-assets transactions.<sup>38</sup>

## VII

### TYPE D—TRANSFER OF PART OF ASSETS TO A CONTROLLED CORPORATION

Suppose Transit stockholders desire to retain the "Surplus Building", not needed in its foundry business, and transfer only the remaining assets to Ack?

A. This does not qualify as a reorganization, and Transit (or A and B, on distribution) would owe a tax, based on the value of the Ack stock and property received. The reason: neither Transit nor its shareholders end up in "control" of Ack (§ 368 (a) (1) (D) ).

B. Could Transit transfer the business assets to a new corporation, Splinter Company, which it or its shareholders would control?

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38. The capitulation of the Treasury on the treatment of distributions in kind provides another possible escape valve. If B will not accept the amount of cash proposed, it may be possible to distribute to him the Surplus Building or an interest in that building. Under prior law (*Commissioner v. Hirshon Trust*, 213 F. 2d 523 (1954), and *Commissioner v. Godley's Estate*, 213 F. 2d 529 (1954) ) there was a danger that any appreciation in the value of the building would be taxed as a dividend to B on receipt, through adding the amount of the appreciation to the accumulated "earnings and profits" on the books of Transit. The proposed Regulations attempted to follow the *Hirshon* and *Godley* cases despite the language of the Committee Reports and the indications in the Code to the contrary; but as a result of vociferous objections the final Regulations limit the amount of a distribution in kind which may be treated as a dividend to the earnings and profits of Transit, without inclusion of any unrealized appreciation. See U. S. Treas. Reg. § 1.316-1 (a) (3); INT. REV. CODE OF 1954, § 312; S. Rep. No. 1622, 83d Con., 2d. Sess. 248 (1954); P-H Edition, p. 24.289 on § 312; cf. § 1.316-1 (a) (3) of the proposed regulations, 19 F. R. 8253.

## TAX—FREE SALE OF A BUSINESS

1. The transfer to the new corporation might be tax free under section 351, but

2. The subsequent distribution of Splinter stock to Transit's shareholders would not be tax free unless: (a) the transaction qualified as a spin-off, etc. under section 355 (and met the requirement that assets transferred constitute an "active trade or business" carried on for 5 years), or (b) the Surplus Building, with the Splinter shares received, is handed over to A and B, with the resulting capital gain and/or dividend tax to them.

C. The combined effect of section 368 (a) (1) (D), section 368 (a) (2) (A) and section 354 (b) is therefore "all or nothing at all"; if Transit tries a transfer of part of its assets, rather than "substantially all" as required in Type C, it must either liquidate or meet the spin-off requirements of section 355.

### VIII

#### DIVIDING UP THE CORPORATION—SPLIT-UPS,

#### SPLIT-OFFS AND SPIN-OFFS

Assume Ack Corporation merges Transit Company through an A-type reorganization in 1955, with all shareholders receiving voting common stock in the new Rack, Inc. (100 to X, 35 to A and 15 to B). Then in 1957, dissension or other factors dictate a division of the enterprise.

A. Could the foundry business be separated? Yes, *provided* (as of 1957):

1. This foundry, as an "*active trade or business*," was actively conducted by Transit, by Rack as its successor, or by both corporations, throughout at least a 5-year period ending on the date of distribution, and the foundry business is continued immediately after the distribution (§ 355 (b) ).<sup>39</sup>

2. The remaining machine tool business was conducted by Rack, by its predecessor in reorganization, or by both of them for a similar 5-year period and is continued after the separation, and

3. The transaction is not principally a device for the distribution of earn-

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39. Note that a business *purchased* within five years would not qualify. Since Transit was acquired in a tax-free reorganization, you "tack on" the time Transit actively conducted the business to the time it was actively conducted by Rack in figuring the 5 years (§ 355 (b) (2) (D) (ii) ).

ings. A subsequent sale of the distributed shares (representing the foundry business) is not of itself determinative of this; but negotiations or an agreement for such sale carried on before distribution are damaging (see § 355 (a) (1) (B) and U. S. Treas. Reg. § 40 1.355-2 (B) )—shades of *Court Holding*!<sup>41</sup>

B. *Methods of separation.*

1. *A Split-up*—Rack transfers the foundry business to new Splinter Company, the machine tool business to new Silver Corporation, distributes Splinter and Silver stock to A, X and B, who surrender or exchange their Rack stock; and Rack dissolves. This was permissible as a Type D reorganization under prior law.

2. *A split-off*—Rack transfers the foundry to Splinter, exchanges Splinter stock with A, B and X for part of their Rack stock (sometimes permissible under prior law as a Type D), with Rack continuing in business, operating the machine tool branch.

3. *A spin-off*—Rack transfers the foundry to Splinter, distributes Splinter stock to A, B and X, without exchange or surrender by the shareholders of any of their Rack stock. Partly because the "spin-off" did not take the form of an exchange, but a distribution, but principally because of judicial and legislative reaction to the situation in the *Gregory* case, this was not permitted for many years, despite its similarity to a split-off, until the 1951 Act added section 112 (b) (11) to the 1939 Code. But even the 1951 amendment permitted a spin-off only through a "reorganization". It was therefore necessary under section 112 (b) (11) that the Splinter stock be transferred to a further corporation—whose only function would be to hold the Splinter stock, but which could qualify as "a corporation a party to the reorganization".<sup>42</sup>

C. *Mechanics under 1954 Code:*

1. If the foundry business is operated directly by Rack Corporation as a mere division or department, it must first create a subsidiary (so that the assets remain "locked in" a corporation) before distribution; but if the foundry is already in a subsidiary, the stock in the subsidiary may for the first time in the history of the corporate separation be distributed directly to the Rack share-

40. See footnote 6, *supra*, for source of regulations.

41. *Commissioner v. Court Holding Co.*, 324 U. S. 331 (1945), the case which highlighted the danger of the double tax on the sale and liquidation of a corporation's assets where negotiations by the corporate officers preceded the shareholders' sale. Section 337 largely eliminates the problem on liquidations.

42. INT. REV. CODE OF 1939, §§ 112 (g), 112 (b) (11).

## TAX—FREE SALE OF A BUSINESS

holders, *without the necessity of a reorganization* (§ 355 (a) (2) (C) ). All of the subsidiary's stock must, except on the Commissioner's approval, be transferred (§ 355 (a) (1) (D) ).

2. As under the 1939 Code (§122 (b) (11) ), no surrender of stock in Rack for the Splinter shares is necessary (§ 355 (a) (2) (B) ) to qualify the separation as tax free. But consider whether an *exchange* and the choice of a split-off rather than a spin-off may not be preferable or necessary in these situations:

(a) If A, B and/or X are to receive "boot" in addition to Splinter stock, the dividend treatment of the boot, if any, may be more favorable in an exchange. For example, if B surrenders stock in Rack for delivery to him of (i) the Splinter shares plus (ii) \$1000, the only part of the cash taxable to him is the amount of his gain, and the only part taxable as a dividend is his *ratable share* of the "earnings and profits" (earned surplus) on Rack's books or the cash distributed to him, whichever is less, and then only if the distribution has the "effect" of a dividend (§ 356 (a) (2) ). Since B owns 15 Rack shares out of 150 outstanding, or 10%, the maximum taxable to him as a *dividend* is \$100. But if B receives the Splinter stock and cash in a *spin-off*, the cash may be automatically taxed as dividend (subject to the provisions of sections 301 and 316) in the amount of \$1000, if Rack's earned surplus is at least that sum, regardless of what B's pro rata share might be (see U. S. Treas. Reg. § 1.356-2 (a); Friedman, *Divisive Corporate Reorganizations under 1954 Code*, 10 TAX L. REV. 507 (1955)).

(b) If "securities" in the new foundry company (Splinter) are to be received in the separation, there must be an exchange of securities (§ 355 (a) (1) (A) (ii) ).

D. *Could A and B be given the machine tool business and X the foundry business by having X surrender his Rack stock, and distributing to X all of the Splinter stock?*

*Yes*—the continuity-of-interest rule is relaxed here; under section 355 (a) (2) (A) distributions need not be *pro rata*, and under section 368 (a) (1) (D) only "one or more" of Rack's shareholders need end up in control of Splinter Corporation.<sup>43</sup>

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43. *Caveat*: Here, as under section 351 transfer on the organization of a corporation, a disproportionate distribution of Splinter stock in some circumstances could conceivably mean treatment as compensation, gift, etc. (§ 356 (f) ).



E. *How about spinning off the "Surplus Building"?*

(1) Alone? It is probably not an "active trade or business", even if held for rental. (U. S. Treas. Reg. § 1.355-1 (d), Example (2) ).

(2). With the foundry business? There is the danger the Surplus Building will be "boot," if no longer used in the business.

F. *What can be "spun off":*

The Regulations in effect define "active business" to exclude holding property for investment only, and require that the segment being separated constitute an existing group of activities, operated for profit and independently producing income (U. S. Treas. Reg. § 1.355-1 (c) ). The effort of the Treasury in the final regulations to make the definition even more stringent by requiring the inclusion in the activities transferred of "every operation which forms a part of, or a step in the process of earning income" is not warranted by the statute or legislative history.<sup>44</sup>

Separations the regulations *approve* include: An office building partly occupied, partly rented by a bank; wholesale and retail activities; a plant and business in one state from a plant and business in another (but not if the out-of-state plant is a new branch); and a suburban from a downtown store, where "no common warehouse is maintained."

*Disapprovals* in the regulations include: Land or buildings substantially wholly occupied and used in the business of the owner corporation (factory building of a hat manufacturer); a research and development department (not theretofore independently income-producing); and vacant land held by an office building company.

What may be a serious departure of the final regulations from the expectations created by the adoption of section 355 is the refusal, in example (11) of section 1.355-1 (d), to approve the separation of the manufacturing from the selling activities of a corporation engaged in the processing and sale of meat products. The comment that this is a "single integrated business" which cannot be divided into fragments for spin-off purposes—which makes some sense—may save some ambitious projects of divorcement.

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44. The quoted phrase was not included in the proposed regulations (19 F. R. 8270). The committee Reports were concerned in this area primarily with "not permitting the tax-free separation of an existing corporation into active and inactive entities." S. REP. No. 1622, 83d Cong., 2d Sess. 51 (1954),

On the other hand, it would seem clear that a corporation is engaged in the "active conduct" of more than one "trade or business" even if there are certain selling, administrative or custodial functions or facilities used in both business activities. There is an unjustified assumption in the example added in the final regulations<sup>45</sup> that the statute (which does not speak of "distinct" businesses) prohibits a separation unless the business activities are independent of each other, or unless any common operation, like a sales or office force, can be divided up and allocated. The statement of facts in example (10), the separation of a downtown from a suburban store, implies that if the stores used a common warehouse a tax-free spin-off would not be permitted—presumably because the warehouse could not be divided vertically! If the corporate separation results in distortion of income as between the two companies, the Commissioner may still invoke his power under section 482 to allocate gross income between affiliated corporations to prevent tax evasion, at least until a sale is made. While the Commissioner's success with the power of allocation has not been phenomenal,<sup>46</sup> neither that fact nor the Treasury's historical hostility to the spin-off should result in an arbitrary limit on the scope of section 355.

G. *Preferred stock* of Splinter Corporation may be distributed, and is not "boot", but may on subsequent sale or redemption be "section 306 stock" producing ordinary income (U. S. Treas. Reg. § 1.355-3 (b) ).

H. "*Securities*" distributed in excess of those surrendered are boot in the amount of the fair market value of the excess. If the *face* value of the securities received is equal to or less than face value of securities surrendered, the securities are not "boot", regardless of market values. (§ 356 (d), following *Neustadt's Trust*, 131 F. 2d 528 (2d Cir. 1942). )

I. *Effect of a separation on surplus account.* You must allocate earnings and profits in ratio of the market values of the assets or businesses distributed and retained. There can be no allocation of a deficit to Splinter Corporation (U. S. Treas. Reg. § 1.312-10 (c) ).

That the Internal Revenue Service is still haunted by the *Gregory* case, and that requests for rulings on spin-off situations may be dangerous or futile, is indicated by a recent pronouncement, Rev. Rul. 55-103, 1955-1 CUM. BULL. 31. Translating the facts and the ruling to our case: A purchaser desired to buy the foundry business represented by the stock in Splinter Corporation, but refused to buy the remaining assets consisting of the machine tool business. Suppose further

45. Compare examples 10, 11 and 15 in U. S. Treas. Reg. § 1.355-1 (d).

46. See *Chelsea Products, Inc.*, 16 T. C. 840 (1951), *aff'd* 197 F. 2d 620 (1952).

that it is proposed that the stock in the subsidiary corporation, Splinter, be distributed to the stockholders of the corporation we call "Rack" in a corporate separation under section 355 of the 1954 Code. Stating that the distribution was "merely a device to give the . . . stockholders certain assets for which the prospective purchaser of their stock is unwilling to pay", the Service held that the transaction was an arrangement for distributing the earnings and profits of the parent company, and section 355 was not available. If the negotiations for the sale had not taken place prior to the submission of the plan of corporate separation, it is hard to see how an unfavorable ruling could be issued without emasculating section 355.<sup>47</sup>

J. *Spin-offs and "thin corporations"*.

No doubt most lawyers are aware of the trend in recent years to organize a corporation by having original owners receive for their capital contribution, instead of only stock, part stock and part notes, debentures or other "debt" instruments. The primary purposes of the use of debt are: (a) the interest on the notes is deductible by the corporation, while the dividends paid on stock are not; (b) when the corporation has acquired earnings, the debt, if true debt, may be paid without fear of a taxable dividend to the stockholder who owns the note which is paid, while a redemption of stock, if pro rata (or otherwise not within the exceptions in section 302 (b) of the Code) may result in a taxable dividend to the stockholders whose shares are turned in. If the investment allocated to the shares of stock is nominal only, or is small as compared to the investment allocated to the notes or other debt instruments, the Treasury may attempt to deny the deduction of the interest on the ground that the company is a "thin corporation," and the notes are not true debt but merely stock in disguise, so that what appears to be interest will turn out to be dividend.

Recent decisions in this field have indicated that use of the "thin corporation" device may have unexpected consequences.<sup>48</sup> If the capital structure is unsuccessful in withstanding the Treasury assault, not only will the interest paid on the "debt" be nondeductible, and payments on the notes treated as taxable dividends, but the conversion of the "notes" by the Treasury into "stock" may convert a high-basis purchase into a low-basis reorganization<sup>49</sup> — a serious consequence in this era of continued inflation and accelerated depreciation.

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47. Compare *Rena B. Farr*, 24 T. C. No. 38 (1955), approving a split-off of a new building and lot where the stated purpose was to meet the requirements of a Studebaker franchise. (1939 Code).

48. See Treusch, *Corporate Distributions and Adjustments, Recent Case Reminders of some Old Problems Under the New Code*, 32 TAXES 1023 (1954).

49. See *Estate of Herbert B. Miller*, 24 T. C. No. 103 (1955).

## TAX—FREE SALE OF A BUSINESS

Even if the thin capitalization withstands attack, the top-heavy debt structure, especially if the business is held in a subsidiary, may produce serious obstacles to a subsequent corporate separation. Paragraph (D) of section 355 (a) (1) requires the distributing corporation in a spin-off, split-off or split-up to distribute "all of the stock and securities in the controlled corporation held by it immediately before the distribution". If the debt instruments are in fact distributed and no securities are surrendered in exchange, then the combined effect of sections 355 (a) (1) (D) (i) and 356 (d) is to subject the shareholder receiving the shares and securities in the spun-off corporation to possible capital gain or dividend tax on the principal amount of securities received.

For example, suppose Sliver Corp. is organized with a capital structure of \$20,000 in stock and \$80,000 in notes, and subsequently it is decided to "spin-off" Sliver Corp. to B. Both the stock and notes must be distributed to B to qualify the transaction under section 355, but the result will be that the \$80,000 of notes will be taxable to B, either as capital gain or ordinary income — a consequence which would not follow if just stock had been used in establishing Sliver's capital structure.

The only alternative is to be prepared to satisfy the Treasury that some shares of stock as well as securities were retained, and that the retention "was not in pursuance of a plan having as one of its principal purpose the avoidance of federal income tax" § 355 (a) (1) (D) (ii) ). Otherwise the taxpayer might be called up to urge that his company's capital structure, which he once stoutly held to be "fat", has become "thin", and the "securities" distributed in the spin-off were not securities at all, but "stock"!

## IX

### REORGANIZATIONS INVOLVING FOREIGN CORPORATIONS

Since the State borders on Canada, New York Lawyers may be interested in the application of the new provisions where, for example, Ack is a U. S. corporation, and Transit is organized under the laws of Canada. Section 367, like section 112 (i) of the 1939 Code, requires a prior ruling from the Commissioner that a corporate reorganization or separation involving a foreign corporation does not have tax avoidance as one of its principal purposes. Otherwise, without some form of tax extradition, the foreign transaction might escape tax.

Suppose you have a situation in which a Canadian parent corporation (Rack) proposed to spin-off a separate business conducted by its U. S. subsidiary (Splint-

ter)? Here, the Commissioner has refused to rule in advance (i.e., held that no ruling is necessary under section 367 of the Code), where the foreign company's only role is as receiving parent or stockholder (R. R. 55-45, I.R.B. No. 5, p. 7).

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The game of chess is over. And while some heads may be rolling, let us hope none are nodding. If, despite these pages, the problems of A and B, Transit and Ack, and Splinter and Sliver still seem complex, the fault, dear reader, is not in ourselves, but in the interplay of the forces of corporate finance, the ingenuity of tax planners, and the counter-measures of the watch-dogs of the Treasury. This paper will have accomplished its purpose if, despite "spin-offs", "boot", distributions in kind, and some of the other techniques and jargon which appear to have some of the aspects of prestidigitation, the tax reorganization no longer seems "a sort of hocus-pocus science".