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TAXING DISTRIBUTIONS PURSUANT TO CORPORATE REORGANIZATIONS

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"DISTRIBUTIONS" implies that we are concerned with the tax problems of the stockholder rather than those of the corporation. And while one corporation may be the stockholder of another, my emphasis will be primarily upon stockholders who are individuals, including, of course, trusts and estates who are taxed as individuals.

A stockholder who makes an exchange or receives a distribution in connection with a corporate reorganization faces one or a combination of these possibilities:

(1) There may be no immediate effect upon his tax liability. Any gain or loss is not recognized under section 112, but the tax consequences are deferred until the newly received property, or the balance of his old stock or securities, is disposed of in a taxable transaction. While we frequently refer to such transactions as "tax-free" or "tax-exempt," it should always be kept in mind that we are not dealing with a tax exemption, but rather with deferment of tax. It is also to be kept in mind that losses as well as gains are deferred.

(2) Some or all of what the taxpayer receives in the transaction may be taxed as capital gain.

(3) Some or all of what he receives may be taxed as an ordinary dividend.[1]

I need not elaborate upon the widely varying tax liabilities dependent upon these alternatives.

These reorganizations and recapitalizations are transactions well out of the ordinary course of business and are frequently of major importance from the standpoint of the corporation and its stockholders. The stockholder may be exchanging stock or securities representing his entire interest in the corporation for new stock or securities of the same corporation or of a different corporation. If gain is recognized it will be based upon the present fair market value of what he receives, less his cost for what he turns in. This gain may represent an appre-

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[1] Another possibility is that gain or loss is not recognized at the time because the property received by the stockholder has no fair market value, a subject which is outside the scope of this discussion.

ciation in value accrued over many years. Or the stockholder may be receiving new stock or securities representing the bulk of the present value of his holdings, with the value of the old stock that he retains being correspondingly diminished. In a great many of the situations that have come to litigation, closely held corporations are involved, and it is the reorganization or recapitalization of such corporations that tends to give rise to most of our current questions. In many of these situations, his interest in the corporation represents the bulk of the stockholder's fortune. Even at capital gain rates, a tax imposed upon such a profit may be grievously burdensome, particularly since the recognized gain may still be only a "paper profit." If this profit is taxed as an ordinary dividend, surtax rates being what they are, the result may be financial ruin. If we think of a tax determination as a contest of wits, the game at this table is for extremely high stakes.

It follows that corporate recapitalizations or reorganizations are not to be lightly undertaken. They require the most careful scrutiny by the corporate officers, the stock and security holders, and their advisers.

In sections 203 and 204 of the Revenue Act of 1924, elaborating upon rudimentary provisions in the 1921 act [sections 202(c) to (e)], Congress adopted the basic provisions now found in sections 112 and 113 of the Internal Revenue Code. It was generally believed that the purpose of these initial provisions was to prescribe a set of definite rules that could be understood and followed, both by the Bureau of Internal Revenue and by taxpayers. For some years this was done. But over the past ten to fifteen years there has been a series of developments, spurred by a number of Supreme Court decisions, so that today one must go far beyond the statute to ascertain what one can or cannot do without serious tax penalty.

Administration spokesmen, and sometimes the courts, lay the blame for this development at the taxpayer's doorstep. They speak with some heat of attempts to cloak what are essentially sales and dividends under the guise of reorganizations, and of elaborate procedures within the language but not the "spirit" of section 112. Taxpayers and their representatives can speak, with equal feeling, of opportunism by revenue agents and conferees, and of their urge to impose tax, which often seems as strong as that of a taxpayer to avoid it. They, too, can stress the equities or the technicalities, as it suits their purpose. Since the bureau policy has long been to devote the most attention to the returns of larger taxpayers, and since the potential tax liabilities are generally large, any such urge on the part of a tax administrator has ample scope in the reorganization field.

However, it is not my purpose to debate the cause of this development. Rather, it is to face the situation as it has now developed, pausing only to note that the statutory provisions are only a point of departure. New concepts, by way of both restriction and extension, have been deliberately engrafted on the statute. These are hinted at but not fully outlined in the Treasury regulations, with their talk of inherent and underlying assumptions.

The term "corporate reorganizations" implies a transaction within the general scope, or at least shooting distance, of sections 112 and 113. I assume we are all generally familiar with the language of these provisions. Transactions in this field take many forms and have many objectives. For convenience, we can consider in turn several major reorganization patterns. The simplest of these, making it our best starting point, is the recapitalization. Distribution problems in connection with recapitalizations find substantial parallels through all the other major reorganization patterns.

Corporate Recapitalizations

Unlike other types of reorganization, a recapitalization is not defined in the statute, and its nature is only partially indicated by examples in the regulations.[2] The Supreme Court has recently expressly refused to state its definition, preferring to approach it by the process of including or excluding each situation as it arises.[3] This process may be the most satisfactory from a judicial standpoint, but it gives little assistance to the taxpayers who have a legitimate interest in a reasonable estimate of their tax liabilities before entering into a specific transaction. For present purposes we may take as a rough definition of a recapitalization a rearrangement of the financial structure of a single corporation, affecting either the stock or the indebtedness, or both.

The pertinent statutory provision is section 112(b)(3) providing that 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. For the moment, we may disregard the last clause, since even a closely affiliated corporation is not a party to the recapitalization of its affiliate.[4] We are

[2] Treas. Reg. 111, §29.112(g)-2.

[3] Bazley v. Commissioner, 332 U.S. 752, 67 S.Ct. 1489 (1947).

[4] F. T. Bedford, 2 T.C. 1189 (1943), affd. on another ground (2d Cir. 1945) 150 F. (2d) 341.

also, of course, concerned with section 112(g)(1) which, under clause (E), includes a recapitalization as a reorganization.

From the stockholder's standpoint, the transaction with which we are concerned is an exchange of all or part of his old stock or securities for new stock or securities of the same corporation.

(1) *The Fully Qualifying Exchange.* If the statutory requirements, written and implied, are met, the individual's paper gain or loss, no matter how large it may be, will not be recognized for tax purposes. The cost or other statutory basis of his old stock or securities will be equitably apportioned to the new stock or securities. This result will follow even though the exchange may have some of the attributes of a distribution.

For example, suppose old common stock is exchanged for new common stock of greater par or stated value, the difference representing a capitalization of earnings. It is not necessary to stand upon the constitutional limitations affecting stock dividends specified by *Eisner v. Macomber,*[5] or the alternative theory of statutory construction advanced in *Helvering v. Griffiths,*[6] or upon the simple provision of section 112(b)(2), since this exchange seems fully protected by sections 112(b)(3) and (g)(1)(E).

Likewise, the excess received by the stockholder may represent the satisfaction of dividend arrearages. Numerous cases assert that this is a nontaxable exchange.[7] And where bonds are turned in for new bonds or stock, the issuance of stock or stock purchase warrants in lieu of accrued interest on the bonds is not taxable.[8]

(2) *The Exchange That Does Not Qualify.* On the other hand, if the statutory requirements are not met, there is an immediate taxable

[5] 252 U.S. 189, 40 S.Ct. 189 (1920).

[6] 318 U.S. 371; 63 S.Ct. 636 (1943).

[7] Morainville v. Commissioner, (6th Cir. 1943) 135 F. (2d) 201; Okonite Co. v. Commissioner, (3d Cir. 1946) 155 F. (2d) 248, cert. den. 329 U.S. 764, 67 S.Ct. 125 (1946); Thermoid Co. v. Commissioner, (3d Cir. 1946) 155 F. (2d) 589; Skenandoa Rayon Corp. v. Commissioner, (2d Cir. 1941) 122 F. (2d) 268, cert. den. 314 U.S. 696, 62 S.Ct. 413 (1941); South Atlantic Steamship Line, 42 B.T.A. 705 (1940); J. Weingarten, Inc., 44 B.T.A. 798 (1941), appeal dismissed (5th Cir. 1942); Knapp Monarch Co., 1 T.C. 59 (1942), affd. on another issue (8th Cir. 1944) 139 F. (2d) 863; Globe-News Publishing Co., 3 T.C. 1199 (1944).

It appears necessary that the capitalization of dividend arrears be part of an exchange involving the stock which gave rise to the arrearage. See Bedford v. Commissioner, (2d Cir. 1945) 150 F. (2d) 341, affg. 2 T.C. 1189 (1943).

A number of these cases dealt with the corporation's dividends paid credit, and it was the government that contended that no taxable distribution was involved.

[8] Lenore Scullin Clark, 7 T.C. 192 (1946), affd. (8th Cir. 1947) 162 F. (2d) 677; Wm. W. Carman, 13 T.C. 1029 (1949).

event. In the more complicated reorganizations, it may be difficult to meet the statutory definition of a reorganization or other statutory requirements. This does not frequently occur with recapitalizations, since the statutory phrase is generally given broad scope, as indicated by the foregoing examples. But a failure to meet the statutory requirements is still possible. For instance, what the taxpayer gives or receives may not be a "stock or security," in the meaning of section 112(b)(3). The meaning of "stock" does not ordinarily present much of a problem. "Securities" is another matter, since 1933 when the Supreme Court made its first major qualification of section 112 in *Pinellas Ice & Cold Storage Co. v. Commissioner,*[9] holding that short term purchase money obligations were not "securities." This opened a field of controversy that I will not attempt to discuss here, although the existence and importance of this question must not be ignored.

If there is such a failure, the taxpayer is treated as if he had sold his old stock or securities for a price equal to the fair market value of what he receives, stock, securities, money or other property. His cost of the old securities is deducted from this amount and the difference, reflecting the appreciation in value, is recognized and taxable, although represented solely by the new stock or securities, i.e., a paper profit.

In the simple case, where only new stock or securities of the same corporation are received by the taxpayer, the profit so recognized will be taxed as capital gain. But this relatively favorable tax treatment cannot be taken for granted. There may be dividend possibilities, as will appear from our later discussion.

(3) *The Exchange With "Boot."* Let us now assume that our taxpayer turns in common stock in exchange for new stock plus cash or a distribution in kind of some corporate property.

The tax consequences of this transaction are clearly outlined by the statute. Had it not been for the money or other property, commonly referred to as "boot," this would have been a nontaxable exchange. But where boot is involved, section 112(c) comes into operation. Subsection (c)(1) provides that the gain, if any, shall be recognized, but in an amount not in excess of the boot. But subsection (c)(2) provides that if a distribution made in pursuance of a plan or reorganization, otherwise within the scope of (c)(1), has the effect of a distribution of a taxable dividend, then it shall be taxed as a dividend to the recipient.

When does a reorganization distribution "have the effect of a taxable dividend?" The first requirement is that the corporation have

[9] 287 U.S. 462, 53 S.Ct. 257 (1933).

earnings and profits available for distribution, since a "dividend" occurs only when there are such earnings. In other words, the definition of a "dividend" in section 115(a) is incorporated by reference in section 112(c)(2).[10]

If there are such earnings, dividend treatment under section 112(c)(2) is virtually automatic.[11] There is no correspondence in the decisions between these distributions and distributions in partial liquidation where section 115(g) is in issue and where finespun distinctions are often drawn.

A second limitation is found within section 112(c)(2), namely, that the amount taxable as a dividend thereunder shall not exceed the amount of gain recognized under (c)(1). For example, if the taxpayer turns in stock that cost him $1,000 for new stock worth only $800 and cash of $300, his actual gain is only $100. Hence only this amount should be taxed as a dividend under section 112(c)(2), although cash in a greater amount was received.

But in such a case the government might shift its ground and contend that this transaction was to be eyed from the viewpoint of section 115(g) as a distribution in partial liquidation. The results of this contention are difficult to predict. The question is whether section 112(c)(2) is to be given complete precedence over section 115(g), where the receipt of the boot cannot be segregated from the exchange of stock for stock. In most cases, there is appreciation in value of the taxpayer's holdings, and the over-all gain is greater than the amount of the boot. In these cases it is uniformly held that dividend treatment under section 112(c)(2) supersedes the exchange treatment under section 115(c), the general provision relating to both complete and partial liquidations.[12] In these situations it is the taxpayer's ox that is being gored.

10 Commissioner v. Estate of Edward T. Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945). Since a dividend under §115(a) may result if the corporation has earnings during the current taxable year, although it has no accumulated earnings at the time of the distribution, the extent to which a recapitalization distribution is taxable as a dividend may depend upon the extent of earnings after the recapitalization but within the same taxable year.

11 Commissioner v. Estate of Edward T. Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945); Love v. Commissioner, (3d Cir. 1940) 113 F. (2d) 236; Commissioner v. Forhan Realty Corp., (2d Cir. 1935) 75 F. (2d) 268; Commissioner v. Owens, (5th Cir. 1934) 69 F. (2d) 597.

12 Commissioner v. Estate of Edward T. Bedford, 325 U.S. 283, 65 S.Ct. 1157 (1945); Love v. Commissioner, (3d Cir. 1940) 113 F. (2d) 236. The much-bandied case of the Estate of Lewis, 6 T.C. 455 (1946), revd. (1st Cir. 1947) 160 F. (2d) 839, on remand 10 T.C. 1080 (1948), affd. (1st Cir. 1949) 176 F. (2d) 646, where accumulated earnings exceeded the actual gain, appears to have been decided upon the assumptions that §112(c)(2), if applicable, supersedes §115(c), and the dividend is to be limited to the amount of the actual gain.

Where there is a mixture of considerations on either end of the exchange, can the taxpayer clarify the application of these provisions by dividing the transaction into two or more steps? For instance, can he exchange part of his stock solely for a new stock or security and sell the balance of his old stock for the boot? In 1938 the Second Circuit said that he could; in 1946 they assured us, with equal positiveness, that he could not. In 1938 the Third Circuit adopted the former view; in 1936 the Fourth Circuit expressed the latter view.[13] We may conclude that the attempt to segregate will be hazardous.

In considering boot cases, we tend to think primarily of boot received by our individual taxpayer. But suppose he is the one who gives the boot. It does not seem to be settled whether this vitiates the entire exchange, considering it as a single transaction, or whether the giving of the boot can be considered as a separate exchange or the purchase of an appropriate part of the new stock or securities.[14]

(4) *The Upstream Exchange.* Where no boot passes and only stock or securities are involved on both ends of the exchange, so far as it appears from the statutory language either a stock or a security may be exchanged for either a stock or a security of an entirely different nature. Thus the regulations recognize that common stock may be turned in for preferred stock, and in reliance upon the statutory language a number of cases have held that preferred stock may be turned in for debentures.[15]

It will be noted that in each of these illustrations the taxpayer is moving from a junior to a senior position within the capital and debt structure of the corporation. For want of a better term, we can refer to a move in this direction as an upstream exchange. Where the taxpayer starts with common stock, he may be converting part of his holdings to

[13] Kelly v. Commissioner, (2d Cir. 1938) 97 F. (2d) 915; Spirella Co. v. Commissioner, (2d Cir. 1946) 155 F. (2d) 908; United States v. Rodgers, (3d Cir. 1939) 102 F. (2d) 335; Starr v. Commissioner, (4th Cir. 1936) 82 F. (2d) 964; Bedford v. Commissioner, (2d Cir. 1945) 150 F. (2d) 341.

Some of this conflict may be attributed to the ill-fated Dobson case, 321 U.S. 231, 64 S.Ct. 495 (1944).

[14] The first approach was considered but decision on that ground was avoided in Hoagland Corp. v. Helvering, (2d Cir. 1941) 121 F. (2d) 962. In some cases recognition of gain or loss on the boot might be deferred under §112(b)(5), dealing with transfers to a controlled corporation, where the individual may turn in property of any nature for stock or securities.

[15] Treas. Reg. 111, §29.112(g)-2. Clarence J. Schoo, 47 B.T.A. 459 (1942); Annis Furs, Inc., 2 T.C. 1096 (1943). Edgar M. Docherty, 47 B.T.A. 462 (1942), approved an exchange of common stock for debentures. In each instance the court found a proper "business purpose" under tests which may no longer be fully applicable. It is necessary, of course, that the debentures qualify as a security. L. & E. Stirn, Inc. v. Commissioner, (2d Cir. 1939) 107 F. (2d) 390.

preferred stock or bonds, and his new or retained common stock will leave him with the same proportionate share of the ultimate equity interest in the corporation. In such cases he is moving toward a position where he can convert part of his interest into cash, applying a part of his original cost to the stock or securities so converted, and hoping to pay a tax limited to capital gain rates at the time of the conversion, without any effect upon his proportionate share of the common stock interest. He may expect to get the cash from the corporation itself, through retirement of his new preferred stock or payment of his new bonds.

If the newly acquired interest is a preferred stock, if and when it is is retired by the corporation the taxpayer may face the danger of a dividend under section 115(g). While the bureau may consider this an imperfect weapon, it is by no means an impotent one. But if the new interest is a bond or debenture, it requires a considerable stretching of the language of section 115(g) to make it applicable when the obligation is paid.

Sharing the government's fear of tax avoidance in these situations, the Supreme Court made a characteristic attack on this problem in the *Bazley* and *Adams* cases.[16] In both cases the stockholders of very closely held corporations turned in their common stock for new common stock and an issue of debentures. In one case surplus was capitalized. In the other the debentures equaled a reduction in the authorized capital. Both corporations had accumulated earnings in excess of the face amount of the debentures. All the courts agreed (although not without dissents) that the debentures were taxable to the stockholders as ordinary dividends.

The Supreme Court pitched its decision upon two grounds. The second ground, having the appearance of an afterthought in the opinion, was that even if there was a reorganization exchange, the debentures would still be taxable as dividends under section 112(c)(1) and (2). In other words, they were boot, the implication being that they were not securities within the meaning of section 112(b)(3). In the *Bazley* case, the Court emphasized that the debentures, although having a ten-year term, were callable at any time by the corporation, "which in this case was the will of the taxpayer" who, with his wife, owned 99.9

[16] Bazley v. Commissioner, and Adams v. Commissioner, 331 U.S. 737, 332 U.S. 752, 67 S.Ct. 1489 (1947), affirming (3d Cir. 1945) 155 F. (2d) 237 (withdrawing a prior opinion, 46-1 U.S.T.C. ¶9135), which affirmed 4 T.C. 897 (1945); also affirming (3d Cir. 1946) 155 F. (2d) 246, which affirmed 5 T.C. 351 (1945), superseding 4 T.C. 1186 (1945). Several days later, these decisions were applied in Heady v. Commissioner, (7th Cir. 1947) 162 F. (2d) 699.

per cent of the outstanding stock. This raises an interesting speculation as to the extent that the classification of an indebtedness as a security should depend upon whether the stock of the corporation is closely or widely held. In the *Adams* case twenty year debentures without the call feature were involved. It seems difficult to avoid classification of such obligations as securities within a reasonable meaning of that term. Perhaps here again the Court felt that the taxpayer, who owned practically all the outstanding stock, could control the time of payment. Another interesting speculation is whether a minority stockholder, not a member of the controlling family, should be taxed in the same fashion.

However, instead of pursuing these speculations, a more fruitful source of discussion is found in the Court's first and major ground for its decision. The lower court decisions had been based upon a lack of "business purpose," harking back to *Gregory v. Helvering*,[17] and attempting to draw a distinction between purposes of the corporation and purposes of the stockholders. What the Supreme Court thought of this approach is not clearly determinable. There are some intimations of disapproval. But it sustained the ultimate conclusion of dividend taxation on a broader ground. After discussion of the purposes and assumptions underlying section 112(g), the Court said:

> "In the case of a corporation which has undistributed earnings, the creation of new corporate obligations which are transferred to stockholders in relation to their former holdings, so as to produce, for all practical purposes, the same result as a distribution of cash earnings of equivalent value, cannot obtain tax immunity because cast in the form of a recapitalization-reorganization."[18]

The Court expressly declined to state its rule in narrower terms lest it merely "challenge astuteness in evading it."[19] The application and implications of this rule are worthy of further consideration. Unlike the Court, the taxpayer cannot lightly brush aside such inquiries. Assuming he is not a fool who leaps without looking ahead, his choice lies between defining boundaries that the Court has declined to fix, or foregoing what may be a legitimate and advantageous transaction.

Is the *Bazley* doctrine applicable only where the corporation is closely held? This circumstance was stressed by the Supreme Court, but even if it indicates an identifiable line of distinction, it seems unsafe to rely upon it as a line of defense.

[17] 293 U.S. 465, 55 S.Ct. 266 (1935).
[18] 331 U.S. 737 at 742, 67 S.Ct. 1489 (1947).
[19] Ibid.

Is the doctrine limited to situations in which all the stockholders are treated alike? Here is room for elaboration. For one thing, sound business motives are more likely to be present when there is diversity of treatment. For instance, suppose some of the stockholders trade part of their common stock for bonds as a step toward their retirement from participation in the future affairs of the corporation. This is different from the distribution of a dividend, as ordinarily conceived. The pro rata participation of all stockholders of the same class, while not a *sine qua non,* is usually an important characteristic of an ordinary dividend. Standards along the lines of those applied under section 115(g) to partial redemptions of stock seem appropriate here. In the given illustration, dividend treatment seems wholly inappropriate, even if the group who get the bonds still retain some of their common, since, as a general rule, one or more stockholders may sell their stock to the corporation and be taxed as the sellers of stock, not as the recipient of dividends.

This was the position taken by the Tax Court in its post-*Bazley* decision in *Marjorie N. Dean.*[20] However, in that case the common was exchanged for preferred stock, rather than for bonds, so that it does not meet our precise illustration. The purpose was to induce inactive women to surrender voting stock, so that the voting power of individuals active in management would be increased. The Tax Court reapplied its business purpose test and held this to be a tax-free exchange.

From the attitude taken by the bureau during the past year, in connection with advance rulings on projected transactions, there are indications that it is sympathetic to this view.

Is the doctrine limited to the partial conversion of common stock into corporate indebtedness? Recapitalization exchanges afford a wide variety of transactions. To how many of these does the *Bazley* rule apply? If there is a downstream exchange, i.e., the taxpayer moves from a senior to a junior security, such as an exchange of bonds for preferred stock, or of preferred stock for common stock, it would not seem proper to invoke the new doctrine. The taxpayer is not segregating cash or the equivalent. He is moving in the opposite direction from any distribution. He is tied in closer than before to the corporation, and the value of his new holdings will be the more subject to the varying fortunes of the corporation in the future.

But what of the upstream exchange? Specifically, if part of the common stock is exchanged for preferred stock, is this, for all practical

[20] 10 T.C. 19 (1948).

purposes, the equivalent of a cash distribution? As noted before, if and when the preferred stock is redeemed, the stockholder must face the tests of section 115(g). Cannot the question of dividend on the whole amount, or capital gain on the actual profit, safely be left until that time? Or is it desirable, as the Treasury seems to feel, to impose the heavy burden of dividend taxation upon all taxpayers who make exchanges of this sort, because some of them may be laying the basis for a sale of the preferred to a third party who may later obtain its redemption without serious danger of a dividend tax under section 115(g)?[21] Are distinctions to be drawn where the preferred stock is callable, or where a sinking fund is contemplated or provided. The crystal ball is our only recourse for answer to these questions at this time.

Suppose that preferred stock is exchanged for bonds. The taxpayer is a step nearer to the cash in the corporate till, and section 115(g) is not, at least according to its literal terms, applicable to the payment of bonds. But if they are trading a limited interest for another limited interest of approximately equal value, say a share of $100 par value preferred stock for a $100 bond, to hold that they have realized a $100 dividend, subject in full to normal tax and surtax, seems unjustifiably harsh.[22] Will the answer lie in treating the bond as a distribution in redemption of the stock and applying section 115(g) or comparable tests? Or will section 112(c)(2) be applied, limiting the dividend to the actual gain on the exchange, although this approach would do some violence to the statute since no "recapitalization" qualifying as a reorganization under section 112(g) may be involved? Will the manner in which the preferred had previously been acquired be a deciding factor, one result being reached where it was received as a stock dividend or in a prior recapitalization, presumably with a low basis, and the opposite result where it was purchased or inherited, with a cost or other basis approaching its par value? These questions likewise are not subject to answer at this time.

21 In a pre-Bazley decision, involving an exchange of part of the common stock for a new preferred stock, used by the taxpayers to satisfy indebtedness incurred in purchasing the common stock, the Tax Court held that a dividend was not involved. Although the Court found that it was not a reorganization for want of a corporate business purpose, and that, the form of an exchange having been followed, the transaction could not be treated as a stock dividend, it treated it as a simple exchange, with no tax because the cost of the common stock turned in exceeded the value of the preferred stock received. Nor was §115(g) applicable because earnings had not been distributed. Louis Wellhouse, Jr., 3 T.C. 363 (1944).

22 In Lelia S. Kirby, 35 B.T.A. 578 (1937), reversed on other issues (5th Cir. 1939) 102 F. (2d) 115, preferred stock was exchanged for bonds equal to the par value plus dividends theretofore declared on the stock, plus a retirement premium. This was held a nontaxable exchange to the extent of the bonds equaling the par value of the stock.

The Supreme Court's own statement of its position, broad as it is intended to be, refers only to a distribution of new corporate obligations. But the implications could apply to any upstream exchange. As with past excursions of the Court into the reorganization provisions, we are left with a great new field of uncertainty.

Whether or not we accept the Court's tacit assumption that such uncertainty is a necessary consequence of the statute—and I for one do not—I would expect few exponents of our economic system to deny that it is unfortunate that heavy—often crippling—tax liabilities should turn upon factors so vague that even the Court can define them only in the most general terms.

Advance Bureau Rulings

What can the taxpayer do in the face of this uncertainty? If a past transaction is challenged—and we must recognize that the *Bazley* rule, like other judge-made tax law, is fully retroactive—he can only argue his case in conference or before the courts to the best of his ability, in the meantime attempting to accumulate a cash reserve to meet payment if the tax should be sustained.

For prospective transactions, we can ask the bureau at Washington for a ruling in advance of the transaction. If the facts are fully stated, it may reasonably be anticipated that a favorable ruling will be followed, even though the future may bring forth radical changes by the courts in the law as it was interpreted at the time of the ruling. The bureau has the power to disregard such a ruling,[23] but as a general policy it has the fairness and the good sense not to do so. Even the lingering fear that the bureau might reverse its ruling after the transaction has been completed can be dispelled by a closing agreement under section 3760, in which event the agreement is final and conclusive, except upon a showing of fraud or malfeasance, or misrepresentation of a material fact.

This course of procedure is not for the hasty taxpayer, for such rulings may take a substantial time in the issuance, particularly if they involve a borderline question. If a closing agreement is requested, still further time will be required.

For a considerable period after the *Bazley* decision, the bureau refused to issue any rulings on questions anywhere within rifle range of its implications. But now, after considerable study, some policies have been evolved, and rulings on some situations are issued with reasonable promptness, at least if the taxpayer's request is made sufficiently

[23] Knapp-Monarch Co., (8th Cir. 1944) 139 F. (2d) 863.

ahead of the year-end log jam. The bureau does not have to honor a request for a ruling. Whether or not it acts at all is wholly within its discretion. Naturally the bureau does not welcome the extra load of issuing rulings on the many requests that have followed the *Bazley* case, but on the whole we have found the bureau sympathetic to the taxpayer's predicament and its attitude on specific questions reasonable under all the circumstances. This course of procedure is likewise not wholly satisfactory from the taxpayer's standpoint but it has seemed to us the most practicable course in many recent situations.

Stock Dividends

Much of the foregoing discussion of recapitalization exchanges is likewise applicable to stock dividends. They differ in form but not in effect from many recapitalization exchanges. For instance, preferred stock might be declared as a dividend on common stock, or common stock might be exchanged for common and preferred stock. While stock dividends do not enjoy the specific statutory protection of a recapitalization, certain types of stock dividends enjoy immunity under decisions of the Supreme Court. While this protection is not as permanent as we might desire, in view of the dissents each time the question has arisen and of the changing complexion of the Court from time to time, nevertheless there does not yet appear to be any overt move to challenge the Court's last guess on stock dividends.

But some hint of the bureau's present attitude may be gained from inspecting rulings issued by it on prospective declarations. For some time most of these rulings have contained an express qualification that the rule will be nugatory if the stock dividend is followed by a sale of the new stock. Before the ruling is issued, the bureau may look closely at such matters as the callability of preferred stock and the presence of sinking fund provisions.

The underlying philosophy might be stated in this manner:

(1) A readjustment of the form of a business entity, or the individual's interest therein, should be freely permitted without a tax penalty, or even with a minimum recognition of any theoretical gain.

(2) But sales as well as dividends cannot be disguised under these provisions. Hence, if an upstream exchange, or a comparable stock dividend, is simply a step by the stockholder toward a salable interest, enabling him to realize part of his investment in cash but still retaining the same proportion of control and benefits attaching to common stock ownership, he may be taxed, forthwith and heavily, at the first step. Since this attitude reaches to cash realizations by sale, it is an extension of the doctrine expressed by the Supreme Court.

Other Reorganization Patterns: Reincorporation

Passing now to other major reorganization patterns, we can quickly dispose of the reincorporation of an existing corporation. The pertinent reorganization definition is found in section 112(g)(1)(F) or possibly (D). As a matter of substance, we are not far from a recapitalization. A new corporation is involved, but it is a complete successor to the old, and is owned by the same interests except such as are retired in the transaction.

The new corporation is likely to be formed under the laws of a different state. In this or other details there may be business reasons for the transaction, ranging from the substantial through the merely plausible to the purely superficial. But unless the business purposes were quite sound, I would not expect to escape the long arm of *Bazley* by planning a reincorporation rather than a recapitalization if, as a part of the transaction, the stockholders were converting part of their old common stock into bonds of the new corporation.

For corporate accounting purposes, all that the new company receives from the old company will be capital or paid-in surplus. But this does not provide a defense against dividend treatment. For purposes of the Internal Revenue Code, a contrary principle of tax accounting applies. By the so-called *Sansome* rule,[24] invented by the courts and not specified by any legislation but expressly taken into account in the old and the new excess profits tax laws, the accumulated earnings of the old company retain their character as earnings in the hands of a successor corporation in a tax-free exchange under section 112. Hence, boot received by the individual participants from the new company will be taxable as a dividend if the old company had accumulated earnings immediately before its succession by the new company.

Spin-offs, Split-offs, and Split-ups

The next type of reorganization involves the division of an existing corporation into two or more entities. The same individuals retain "control" of each entity, although they may part with a minor fraction

[24] Commissioner v. Sansome, (2d Cir. 1932) 60 F. (2d) 931, cert. den. 287 U.S. 667, 53 S.Ct. 291 (1932); United States v. Kauffmann, (9th Cir. 1933) 62 F. (2d) 1045; Murchison's Estate v. Commissioner, (5th Cir. 1935) 76 F. (2d) 641; Baker v. Commissioner, (2d Cir. 1936) 80 F. (2d) 813; Commissioner v. Munter, 331 U.S. 210, 67 S.Ct. 1175 (1947); Commissioner v. Phipps, 336 U.S. 410, 69 S.Ct. 616 (1949); Robinette v. Commissioner, (9th Cir. 1945) 148 F. (2d) 513; Putnam v. United States, (1st Cir. 1945) 149 F. (2d) 721; Estate of Howard H. McClintic, 47 B.T.A. 188 (1942), remanded per compromise, 43-2 U.S.T.C. ¶9599; National Sanitary Co., 6 T.C. 166 (1946), remanded on another issue; Stella K. Mandel, 5 T.C. 684 (1945).

of their interests. This may be accomplished by any of several procedures, for which the currently popular names are the spin-off, split-off, or split-up.

A *spin-off* occurs when *A* company transfers part of its assets to *B* company for stock of *B* company which is then distributed to the *A* company stockholders, who also retain all their original holdings in *A* company.

From 1924 through 1933, this would have been a tax-free reorganization distribution to the *A* company stockholders. It was made so in the 1924 act for the express reason that this same result could have been accomplished by a more roundabout procedure.[25]

But since the 1934 act, form has been fatal to this transaction. Step 1 is a tax-free exchange as to *A* company but step 2 is simply a distribution by *A* company to its stockholders, no different from a distribution of cash or any other property. There is no exchange by the stockholders to bring them within section 112(b)(3). If *A* company has earnings, they have received an ordinary dividend under section 115(a).[25a]

How does the *Sansome* rule of inherited earnings apply here as between *A* company and *B* company? It is a judge-made rule, developed and extended or limited as each new case arises, so that it does not have even the apparent precision of a statutory rule. But here I think it is clear that if *A* company has earnings immediately before this transaction, there will be a dividend, to that extent, when the *B* company stock is distributed to the *A* company stockholders. Since no gain or loss is recognized to *A* company when it creates *B* company, there is no

[25] Section 203(c), Revenue Acts of 1924 and 1926; §112(g), Revenue Acts of 1928 and 1932. The 1924 Ways and Means Committee report stated:

"There is no provision of the existing law which corresponds to subdivision (c). Under the existing law, if corporation A organizes a subsidiary, corporation B, to which it transfers part of its assets in exchange for all the stock of corporation B, and distributes the stock of corporation B as a dividend to its stockholders without the surrender by the stockholders of any of their stock, then such a dividend is a taxable one. If, however, corporation A organizes two new corporations, corporations B and C, and transfers part of its assets to corporation B and part to corporation C, and the stockholders of corporation A surrender their stock and receive in exchange therefor stock of corporations B and C, no gain from the transaction is recognized. Thus, under the existing law, the same result, except as to tax liability, may be obtained by either of two methods; but if the first method set out above is adopted, the gain is taxable, while if the second method set out above is adopted, there is no taxable gain. Subdivision (c) of the bill permits the reorganization to be accomplished in the first manner set out above without the recognition of gain. This method represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute as long as the exemption under the present law is continued." H. Rep. No. 179, 68th Cong., 1st sess., p. 14. The Finance Committee made a similar statement. S. Rep. No. 398, p. 15.

[25a] Since this paper was prepared, the Revenue Act of 1951 has added §112(b)(11) specifically authorizing certain spin-offs.

diminution of its pre-existing earnings by that step. And if, as part of the same transaction, there is a distribution of the *A* company earnings to its stockholders, these same earnings should not at the same time be inherited by *B* company. The *Sansome* rule is not founded upon the continuity of the enterprise, but is designed purely to prevent tax avoidance.[26] Hence it would not be applied to diminish the *A* company earnings and enable the *A* company stockholders to receive a tax-free distribution of the *B* company stock.[27]

A *split-off* is similar to a spin-off except that the *A* company stockholders turn in part of their stock to *A* company in exchange for the *B* company stock. Both steps of this transaction are within the precise language of section 112. The transfer by *A* company of part of its assets to *B* company for stock of *B* company is not only a transfer to a controlled corporation under section 112(b)(5), but is also a reorganization exchange under section 112(b)(4), there being a reorganization under section 112(g)(1)(D) if, immediately after the transfer, *A* company or its stockholders or both are in control of *B* company. *B* company need not be a new corporation, so long as the control requirement is satisfied. It can be an existing corporation already controlled by the *A* company stockholders, or it might be an existing corporation wholly owned by other parties, if the assets coming to it from *A* company justify the issue of enough additional stock to put *A* company or its stockholders into control. Likewise, independent interests might acquire a part of the *B* company stock if this was not sufficient to prevent control by *A* company or its stockholders.

Step 2 is an exchange by the *A* company stockholders of part of their *A* company stock for stock of *B* company within the language of section 112(b)(3). Although it is also a partial liquidation by *A* company, it is still to be treated as an exchange by the express provision of section 115(c).

A *split-up*, the third variation, involves two or more successor corporations, which acquire all of the *A* company assets and issue their stock to *A* company, which is then completely dissolved. Here again each step is a reorganization exchange under section 112(b)(3) and (4).

In practice, the more cumbersome method of the split-up may be the preferable alternative. There appears to be some tendency in official quarters to treat the split-off as a spin-off, as a means of supporting an

[26] Commissioner v. Phipps, 336 U.S. 410, 69 S.Ct. 616 (1949).

[27] By the same reasoning, if the A company stockholders receive a taxable dividend, there is no tax avoidance and no occasion to hold that the same earnings are inherited by B company. Samuel L. Slover, 6 T.C. 884 (1946).

assertion that the distribution of the *B* company stock to the *A* company stockholders is an ordinary dividend. There is at least some psychological barrier to this attitude in the case of a split-up, since, where the *A* company stockholders receive stocks of two new companies, it may be difficult to say which of the new stocks stands in the place of the old and which represents the dividend or other distribution.

Whichever procedure is adopted, the individual stockholders face the same gamut of questions that arise in the case of a recapitalization or reincorporation. Full compliance with section 112 is necessary in order that there be a reorganization exchange under section 112(b)(3). If boot is involved, the stockholders may be taxed upon ordinary dividends under section 112(c)(2). This is true whether the source of the boot is the retained assets of *A* company, or a return of part of the assets of *B* company, or assets previously owned by *B* company, if it was an existing company, or short-term obligations of *B* company given as part of the consideration for the assets but which cannot qualify as "securities."

Finally, the *Bazley* doctrine cannot be disregarded. If, for instance, as part of such a transaction, the stockholders were to attempt to convert part of their old *A* company common stock into bonds of *B* company, this would probably be seized upon as a taxable dividend. All the uncertainties attending any upstream exchange are present in these cases; for instance, the conversion of *A* company common stock into *B* company preferred stock, or of *A* company preferred stock into *B* company bonds.

The Acquisition of One Corporation by Another

Finally, we come to the case in which there is a true succession of one corporation by another, i.e., the acquiring company is an existing corporation into which the interests in the old company are merged. This transaction may take the form of an acquisition of 80 per cent or more of the *A* company stock by *B* company, or the acquisition of substantially all of the *A* company assets by *B* company. The pertinent reorganization definitions are found in section 112(g)(1)(B) and (C). Each of these definitions requires that the acquisition by *B* company must be solely for voting stock of *B* company. Hence the question of whether the transaction qualifies as a reorganization is likely to be of much more importance in these cases than in the types of reorganization heretofore considered.

A third possible form of these transactions is the statutory merger or consolidation, which is a reorganization under section 112(g)(1)(A). Here there is no statutory limitation upon the issue of nonvoting stock or obligations of *B* company to the *A* company stockholders. So with a statutory merger or consolidation, it will be possible for *B* company to pay some boot to the *A* company stockholders, without precluding classification of the transaction as a reorganization. But if there is any boot, the stockholders must face tax upon the receipt of a dividend, for if distribution of the boot has the effect of a dividend, the automatic rule of section 112(c)(2) comes into play. For this purpose, in considering whether there are corporate earnings available for distribution, it would seem appropriate to look to the earnings of either *A* company or *B* company.

It follows that in all of these cases where one existing corporation absorbs another, any boot passing to the stockholders is virtually precluded if a tax-free exchange is desired. It may also be noted that these comments apply to the *B* company stockholders as well as to the *A* company stockholders.

In addition to true boot, the implications of the *Bazley* doctrine must also be considered in these cases. While the acquisition of one corporation by another will, in most instances, be amply supported by sound business purposes, the argument is always possible that, to the extent an upstream exchange was involved, it was not essential to the accomplishment of these business purposes, but was an added feature that may be judged and taxed as a separate issue.

All of these problems are aggravated in many of these absorption cases by the presence of unwanted assets, that is, a part of the assets of *A* company that are not desired by *B* company, or which the *A* company stockholders wish to retain for themselves. Or perhaps *A* company may be willing to merge its interests with *B* company, only if some of the *B* company assets have first been segregated for the *B* company stockholders alone. Discussion of the multiplicity of possibilities that can arise, and of possible or plausible solutions, could alone take the entire time allotted to me. Hence this must be deferred for some other occasion. In the simpler situations that have been considered in some detail, there are ample problems, complexities and uncertainties for the time being.

I regret that this is so, and that I have raised more questions than I can answer. But I expect this haze of uncertainty to continue so long as the courts continue to hold that plain language in the statute cannot be taken at face value and is subject to restrictions and qualifications that can only dimly be foreseen, and that every transaction in the nature of a reorganization may be second-guessed by the bureau and the courts in the light of such qualifications as they develop, and so long as Congress continues to acquiesce in this attitude.