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SOME TAX RISKS IN ASSUMPTIONS OF LIABILITY*

ROBERT B. EICHHOLZ

Among the reorganization provisions of the Revenue Act of 1936 are the following:

Section 112

(b) (4): "Stock for stock on reorganization—gain of corporation: no gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

(d): "If an exchange would be within the provisions of sub-section (b) (4) of this section if it were not for the fact that the property received in exchange consists not only of stock or securities permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then

- (1) If the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange, but
- (2) If the corporation receiving such other property or money does not distribute it in pursuance of the plan of reorganization, the gain, if any, to the corporation shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property, which is not so distributed."

These provisions are to be found in the same sections of the Revenue Acts of 1928, 1932, and 1934, and also in Sections 203 (b) (3) and (e) of the Revenue Acts of 1924 and 1926.

Of late, discerning members of the profession have felt some measure of disquietude as to the precise meaning of the words "other property or money" used in this provision. Little light has been shed upon the problem by the few relevant decisions, but the subject is obviously one which will develop in the next year or two.

At first there was little disposition on the part of the Treasury to give the phrase "other property or money" any but its literal interpretation, but lately there have been some scattered attempts to include within the scope of the phrase a transferee's express or implied assumption of a taxpayer's liabilities. In this article, an effort will be made to show how the Board and the courts have so far responded to these attempts, and to arrive at some tentative conclusions as to the effect of the words in question in connection with reorganization transfers.

*The writer is greatly indebted to Randolph E. Paul, Esq., of the New York Bar, for valuable criticisms and suggestions.

I

The most obvious justification for construing an assumption of liability as "other property or money" is that the contract of assumption is the "equivalent of" money.¹ This was apparently the theory of two General Counsel Memoranda promulgated in 1927² and 1928,³ which first posed the question. It was there ruled that where property subject to a mortgage is exchanged for other property, the gain, if any, is to be determined by subtracting the cost (less the proper depreciation adjustment) of the property transferred from (1) the fair market value of the property received, plus (2) any cash received, plus (3) the net reduction of the transferor-taxpayer's indebtedness. If the resulting gain is less than the sum of (2) and (3), then, under these opinions, the entire gain is taxable; otherwise, it is taxable only up to the total of (2) and (3). The mortgage debt assumed is regarded as part of the consideration paid by the transferee, and hence the equivalent of cash. This argument is the basis of the contentions in *Fashion Center Building Co.*,⁴ decided by the Board of Tax Appeals in 1934, and in *Broms Hotels, Inc.*,⁵ decided by the Board in 1936 in favor of the Government.

The theory originates in the decisions of the Supreme Court in *Old Colony Trust Co. v. Commissioner*⁶ and *United States v. Boston and Maine Railroad*,⁷ embodying the general principle that the discharge of a legal obligation by a third person who receives a consideration therefor constitutes taxable income to the relieved person, since the discharge is equivalent to receipt by the original obligor. In the latter case, the railroad had leased all its properties and ceased operations, the lessee undertaking to pay rent in the form of annual dividends to the railroad's stockholders, and also to

¹The cases first to be discussed arise under the analogous provisions of §§ 112 (b) (1) and (c) (1) of the Acts of 1928 to 1936 inclusive, and of §§ 203 (b) (1) and (d) (1) of the 1924 and 1926 Acts, as follows:

(b) (1): Property held for productive use or investment: "No gain or loss shall be recognized if property held for productive use in trade or business or for investment (not including stock in trade or other property held primarily for sale, nor stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest) is exchanged solely for property of a like kind to be held either for productive use in trade or business or for investment."

(c) (1): "If an exchange would be within the provisions of subsection (b) (1), (2), (3) or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property."

Under this statute the same problems are involved insofar as the actual construction of "other property or money" is concerned.

²G. C. M. 2641, VI-2 CB 16 (1927).

³G. C. M. 4935, VII-2 CB 112 (1928).

⁴31 B. T. A. 167 (1934).

⁵34 B. T. A. 376 (1936).

⁶279 U. S. 716, 49 Sup. Ct. 499 (1929).

⁷279 U. S. 732, 49 Sup. Ct. 505 (1929).

pay any income taxes payable on account of such rent. The Commissioner successfully contended that the payment by the lessee of taxes assessed against the lessor constituted additional income taxable to the latter.

That the assumption of a recurrent liability may be taxable income in such cases is too well established to require further comment here.⁸ But to say that the payment by a third person of a taxpayer's liabilities constitutes ordinary income does not necessarily mean that the assumption of a taxpayer's liabilities in the course of an otherwise tax-free exchange constitutes a capital gain which the statute recognizes. Income in the sense of earnings or returns on capital investments may clearly be in the form of the "equivalent" of cash as well as cash. But where Congress has exempted certain transactions from the purview of the statute and then closely defines certain specified exceptions to the exemption, a somewhat different problem is involved. The question is no longer one of differing metaphysical conceptions of "income"; it is rather one of defining the words "other property or money." A contract of assumption of liability may be the equivalent of money and, therefore, income; but that is not tantamount to saying that it is the equivalent of money and, therefore, money.

Up to the present, the Board of Tax Appeals has not very clearly indicated its reasons for accepting or rejecting the Government argument, and its decisions are in some confusion. In *Fashion Center Building Co.*⁹ it decided that a transferee's assumption of a mortgage did not constitute "other property or money," whereas in *Brons Hotels, Inc.*¹⁰ the opposite position was taken. In the former case, the opinion is regrettably short and far from clear. It is perhaps worthy of note, however, that it was *the transferee-taxpayer who asserted the transfer to be taxable*. He was attempting to establish a higher cost basis for a subsequent sale of the property; the Commissioner had declined to recognize a gain (which he could no longer tax)¹¹ and contended that the basis of the property in the hands of the taxpayer was its cost to his transferor.

⁸For additional cases in which a lessor railroad was held liable to taxation on obligations discharged by its lessee see: *Providence and Worcester R. R.*, 5 B. T. A. 1186 (1927); *Houston Belt & Terminal Ry.*, 6 B. T. A. 1364 (1927) (taxes); *Rensselaer & Saratoga R. Co. v. Irwin* 249 Fed. 726 (C. C. A. 2d 1918); *Northern R. Co. of N. J. v. Lowe*, 250 Fed. 856 (C. C. A. 2d 1918) (interest on bonds); *Houston Belt & Terminal Ry. v. United States*, 250 Fed. 1 (C. C. A. 5th 1918) (interest and sinking fund payments); *Hamilton v. Kentucky & Indiana Terminal R. Co.*, 289 Fed. 20 (C. C. A. 6th 1923) (interest, fixed charges, operating expenses, taxes).

⁹31 B. T. A. 167 (1934).

¹⁰34 B. T. A. 376 (1936).

¹¹The Board evidently did not see the necessity for discussing the mooted question of whether the taxpayer is precluded from claiming a basis because of not having reported income. Seemingly to the effect that the taxpayer is not estopped are: *Helvering v. Salvage*, 297 U. S. 106, 56 Sup. Ct. 375 (1936), *aff'g* 76 F. (2d) 112 (C. C. A. 10th 1935); *E. D. Knight*, 28 B. T. A. 188 (1933); *Minal E. Young*, 6 B. T. A. 472 (1927). Seemingly *contra* are: *Larkin v. United States*, 78 F. (2d) 951 (C. C. A. 8th 1935); *Commissioner v. Farren*, 82 F. (2d) 141 (C. C. A. 10th 1936).

The *Brons Hotels* case contains a fuller opinion, which will bear closer analysis. The petitioner exchanged hotel property subject to a mortgage for an apartment building also subject to liabilities, the other party paying some cash and assuming the mortgage indebtedness and certain other liabilities of the hotel. The Commissioner determined the taxable gain thus:

Cash received		\$ 13,914.62
Mortgage assumed by purchaser		181,666.62
Current liabilities of hotel assumed by purchaser		8,979.07
Unamortized lease assumed by purchaser		14,731.43
Fair market value of apartment property rec'd		100,000.00
		\$319,291.74
Total Received		
Less:		
Cost of land	\$ 72,076.78	
Cost of building	169,991.40	
less depreciation	12,633.00	
	157,358.40	
Current liabilities of apartment assumed by petitioner	10,544.65	
	239,979.83	
Gain taxable		\$ 79,311.91

Since the gain was less than the amount of the mortgage indebtedness assumed, the entire gain was held taxable. The petitioner contended, however, that only the actual cash received was taxable, on the theory that the transaction was merely the exchange of an equity in one building for an equity in another and that the taxation of any gain, except cash actually received, must be deferred until the property acquired in exchange had been sold.

The Board decided in favor of the Commissioner, saying:

"Petitioner's transferee assumed the payment of . . . indebtedness and such assumption was clearly part of the consideration received by petitioner¹² . . . it is the method used in ordinary accounting and is the method specifically recognized by the respondent's regulations and general administrative practice."¹³

and further:

"We are not unmindful of the fact that the assumption of a mortgage is not money in a true legal sense. It is, however, part of the consideration received; it is the equivalent of money, and in our opinion must be treated as money for the purposes of this case. . ."¹⁴

¹²The Board here cites *Old Colony Trust Co. v. Commissioner, and United States v. Boston & Maine R. Co.*, *supra* note 6.

¹³34 B. T. A. 379 (1936).

¹⁴34 B. T. A. 381 (1936).

Six dissenting members of the Board sought to interpret the statute literally; whatever else the assumption of a mortgage might be, in their opinion it was not money.

The majority found other reasons sufficiently cogent to convince it of the necessity of finding a tax deficiency. It reasoned that since the taxpayer had had the benefit of including the amount of the mortgage debt in the cost basis of the property transferred (having actually transferred only an equity in the property), and since the debt had further been deducted as depreciation and taxes upon the entire property and not merely upon its equity, it was only equitable that "it should be deemed to have received cash equivalent in the passing on of that debt to its vendee."¹⁵ But the Board answered this argument itself by acknowledging in the next sentence that it did not possess equity powers.

The majority then proceeded to show considerable concern over a possible complete loss of revenue to the Treasury on hypothetical future transactions by the petitioner.¹⁶ Assuming the petitioner's position to be sound, it was argued that by Section 113 (a) (6) the tax basis of the property received in exchange would be:

Basis same as in the case of the property exchanged.....		\$229,435.18
Decreased in the amount of money received by the taxpayer		13,914.62
		215,520.56
Increased in amount of gain recognized on such exchange		13,914.62
		\$229,435.18
Whereas, by the majority's theory it would be:		
Depreciated cost of hotel transferred		\$229,435.18
Deduct:		
Cash	\$ 13,914.62	
Mortgage assumed	181,666.62	
Net liabilities	8,979.07	
	14,731.43	
	23,710.50	
Less	10,544.65	
	13,165.85	
		208,747.09
		20,688.09
Add gain recognized		79,311.91
		\$100,000.00

¹⁵34 B. T. A. 379 (1936).

¹⁶This argument is voiced repeatedly in the opinions of the courts and Board. See PAUL, STUDIES IN FEDERAL TAXATION (1937) p. 61.

“. . . If, therefore, petitioner subsequently sells the Leland-Malden Apartments—which has a fair market value of \$100,000.00—for less than \$229,435.18, the basis under its theory, then it would be entitled to take a loss deduction when in truth and in fact it not only *suffered no actual loss* but realized a substantial gain.”¹⁷ The dissenting opinion is hard put to answer this, and resorts to a translation of the statute almost as free as that of the majority. It contends that a basis “the same as in the case of property exchanged” may be interpreted to mean the “cost to the transferor less any return of cost which he has received, as by the assumption of the mortgage in the present case.”¹⁸ Such an interpretation is, of course, thoroughly reasonable, and the dissent might have referred to the convenient bromide that it is the province of Congress, not of the courts, to remedy possible deficiencies in the revenue laws.¹⁹

A majority of the Board has thus reached the conclusion that section 112 (c) (1) includes a transferee's assumption of liability, on the ground that such assumption is the equivalent of a cash consideration. The decision in the *Fashion Center Building Co.* case is thereby, to all intents and purposes, overruled,²⁰ and the *Brons Hotels* case becomes the basis for any future contention by the Commissioner that the assumption by a transferee-corporation of the outstanding liabilities of the transferor-corporation constitutes sufficient ground for finding taxable gain to the latter in reorganization transactions.

II

For a long period of years, the Treasury Department made no attempt to impose a tax on corporations transferring all their assets and liabilities to another corporation in exchange for the latter's stock or securities. Thousands of reorganizations have been consummated on the assumption that no such tax would accrue. A certain number of such cases have come before the

¹⁷34 B. T. A. 381 (1936).

¹⁸34 B. T. A. 383 (1936).

¹⁹*Brushaber v. Union Pacific R. R. Co. Co.*, 240 U. S. 1, 36 Sup. Ct. 236 (1916); *Monroe Cider, Vinegar & Fruit Co. v. Riordan*, 280 Fed. 624 (C. C. A. 2d 1922); *Blunt v. United States*, 255 Fed. 332 (C. C. A. 5th 1918); PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.04.

On the problem of statutory construction it is always interesting to compare the conflicting opinions of Judge Learned Hand. In *Helvering v. Gregory*, 69 F. (2d) 809 (C. C. A. 1934) he says: “. . . the meaning of a sentence may be more than that of the separate words, as a melody is more than the notes. . . .” Dissenting in *Pfeiffer v. Commissioner*, 3 C. C. H. 9503 (1937), he says: “Of course, it is always possible to stick to the literal words . . . but that is never a good way to find out what words really mean. . . .” In contrast to the foregoing, is his remark in *Commissioner v. Manus Muller & Co.* 79 F. (2d) 19 (C. C. A. 2d 1935) that “. . . we cannot play so fast and loose with the chosen words of a statute.”

²⁰This is certainly true as to the interpretation of “other property or money,” since the Board said: “In so far as *Fashion Center Building Co. v. Commissioner* is in conflict with the conclusion herein reached, it will no longer be followed.”

Board,²¹ and, with one exception, the issue was raised neither by the Board nor by the Commissioner, the sole question discussed being whether there was in fact a reorganization within the meaning of the statute. In the exception mentioned,²² to be discussed more fully later, the Board expressly avoided construing "other property or money" and rested its decision on another ground. Obviously, this practice in the Treasury Department of long years' standing must be accorded some weight in future decisions,²³ but the *Brons Hotels* case threw so much doubt upon the question that the whole subject had to be re-examined. In his first attempt to impose a tax on liabilities assumed in a reorganization transfer, the Commissioner failed, and the District Court of Maryland in *Hendler v. United States* decided for the taxpayer.²⁴ But there is no indication that there will not be more of such attempts in the future. The question will doubtless have to be decided by a higher tribunal.

That a contract of assumption is a consideration of definite monetary value is scarcely open to question. The same arguments prevail in reorganization exchanges as in other types of transfers previously discussed. Such a contract has been deemed to constitute the equivalent of cash to the recipient,²⁵ and to be a consideration of sufficient value to preclude a transferee liability.²⁶ It has also been held to be part of the cost to the transferee of the assets acquired, so that payments made under the contract are to be considered as capital expenditures and not as ordinary business expenses.²⁷ And, finally, in the absence of a contract of assumption, liabilities must be discharged from money received for the assets transferred, or else from cash realized by a sale of stock or securities received.²⁸

²¹Tulsa Oxygen Co., 18 B. T. A. 1283 (1930); National Pipe & Foundry Co., 19 B. T. A. 242 (1930); G. C. M. 7472, IX-1 CB 184; Frank Kell *et al.*, 31 B. T. A. 212 (1934); W. C. Coleman, 31 B. T. A. 319 (1934); George Whittell & Co., 34 B. T. A. 1070 (1936).

²²The Liquidating Co., 33 B. T. A. 1173 (1936).

²³Universal Battery Co. v. United States, 281 U. S. 580, 50 Sup. Ct. 422 (1930); Cambridge Loan & Building Co. v. United States, 278 U. S. 55, 49 Sup. Ct. 39 (1928); Uniform Printing & Supply Co. v. Commissioner, 33 F. (2d) 445 (C. C. A. 7th 1929), *cert. denied*, 280 U. S. 591 (1929); PAUL & MERTENS, LAW OF FEDERAL INCOME TAXATION § 3.16.

There is a parallel in the question of whether receipt of common stock as dividends on preferred, or of preferred stock as dividends on common, constitutes taxable income. The dissenting opinion of member McMahon in *Jas. H. Torrens*, 31 B. T. A. 787, 803 (1934) lays great stress on the fact that it had long been assumed that such stock dividends were not subject to tax.

²⁴C. C. H. vol. 3, 1937, p. 9270, decided Dec. 30, 1936. This case contains the fullest analysis of the subject to date.

²⁵Stevenson Consolidated Oil Co., 23 B. T. A. 610 (1931); G. C. M. 4935, VII-2 CB 112 I. T. 2168, VIII-1 CB 159.

²⁶Fostoria Milling & Grain Co., 11 B. T. A. 1401 (1928).

²⁷Helvering v. American Chicle Co., 291 U. S. 426 54 Sup. Ct. 460 (1934); Athol Mfg. Co. v. Commissioner, 54 F. (2d) 230 (C. C. A. 1st 1931); Falk Corporation v. Commissioner, 60 F. (2d) 204 (C. C. A. 7th 1932).

²⁸For illustrations see: West Texas Refining & Development Co. v. Commissioner, 68 F. (2d) 77 (C. C. A. 10th 1933) *aff'g* 25 B. T. A. 1254, C. C. H. Dec. 7542 (1932);

A possible distinction, however, between a transfer of assets subject to liabilities and an express contract to assume liabilities has been urged with considerable force by Baar and Morris.²⁹ They argue that, in the former case, the money paid by the transferee in discharge of the liabilities might presumably be recovered from the transferor or its stockholders. Such recovery would amount to a return of part of the original consideration,³⁰ and the transferor would thus have received no benefit from the discharge of its liabilities. A contract to assume liabilities avoids the possibility of recovery and the transferor is thereby enabled to retain the benefit of the entire consideration received. However sound this argument is, it might presumably be contended in reply that a transfer "subject to" liabilities constitutes an implied contract of assumption, which for tax purposes would be the same as an express undertaking and would at least have the merit of preventing taxability from depending exclusively upon the mere form of the transfer.

Granting that an assumption of liabilities constitutes the equivalent of a cash consideration, the question again remains whether it is "other property or money." The Court in *Hendler v. United States*³¹ is in full agreement with the dissenting opinion in *Brons Hotels, Inc.* on this point, but states the reasons for its decision much more completely. It argues that the redemption by the transferee of certain mortgage bonds was clearly not "money," and that, since the word is unambiguous, it is insufficient to say that such redemption is the equivalent of money. Nor is it "property" in the ordinary meaning of that word,³² although if the liabilities are not discharged a chose in action arises. In effect, this means that a contingent contract right is certainly not *ipso facto* taxable under the terms of Section 112 (d).³³ In

Minnesota Tea Co. v. Commissioner, 76 F. (2d) 797 (C. C. A. 8th 1935), *rev'd* 28 B. T. A. 591, C. C. H. Dec. 8147 (1933); National Pipe & Foundry Co., 19 B. T. A. 242, C. C. H. Dec. 5901 (1930).

²⁹BAAR & MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS (1935) pp. 261-262.
³⁰A possible analogy to this contention is to be found in cases limiting the doctrine of United States v. Kirby Lumber Co., *supra*, and Helvering v. American Chicle Co., *supra*, note 27. Thus it has been held that discharge at less than its face value of an indebtedness which is not the personal obligation of the taxpayer, but is only a lien against his property, does not realize income. Such a transaction, at most, reduces the cost basis of the property subject to the lien. P. J. Hiatt, 35 B. T. A. (1936); Fulton Gold Corp., 31 B. T. A. 519 (1934); Union Pacific R. Co., 32 B. T. A. (1935); American Seating Co., 14 B. T. A. 328 (1928); A. M. Lawrence, 13 B. T. A. 463 (1928). Not being a personal obligation, discharge does not set free assets which would presumably have to be applied in payment of the indebtedness.

³¹3 C. C. H. 9270 (1937).

³²But see *Lucas v. Schneider*, 47 F. (2d) 1006 (C. C. A. 6th 1931), *cert. denied*, 284 U. S. 622 (1931), wherein a purchaser's assumption of mortgages was held to be "property" to be included as part of "initial payments" in determining whether a sale was an "installment sale" within § 212 (d) of the Revenue Act of 1926.

³³The court also questioned whether the Commissioner's contention was in fact based on a theory that any assumption of liability constituted "other property or money," since he attempted to impose a tax only on the bonded indebtedness assumed, ignoring both current bank loans and accounts payable.

answer to the *Brons Hotels* case, the opinion states that of course the assumption of the bonded indebtedness is a valuable consideration which may be considered in ascertaining the whole value realized by the vendor to determine loss or gain as taxable income, "but it is not the function of 112 (d) to measure gain—it assumes there has been gain and determines whether and to what extent it shall be recognized."³⁴ If this means anything, it is an oblique reference to the suggestion of the minority in *Brons Hotels, Inc.*, namely, that the sum of the liabilities assumed, instead of being added to the consideration received, should be deducted from the cost of the assets transferred.³⁵ Such a procedure is also approved by Baar and Morris³⁶ when the liability represents a lien upon the property, but they quite properly can see no justification for it in the case of an unsecured indebtedness. However, with respect to property subject to a mortgage, it seems to be the wisest solution offered, since as was said in *Hendler v. United States*:

"In financial substance Hendler merely exchanged its equity in its property for shares of stock in the Borden Co. which represented only the equity therein, and which pro tanto were diminished in value by the Hendler liabilities assumed by Borden."³⁷

The "pro tanto" is not literally true, since Borden's greater capitalization dilutes the diminution per share caused by the assumption of the Hendler liabilities. Nevertheless, the argument seems cogent, especially in view of the expressed intent of Section 112 (b) not to recognize taxable gain in cases of exchanges solely in kind.

Apart from these considerations, however, the construction to be given "other property or money" must, in the last analysis, depend upon a broad interpretation of the statute. Inherent in the Government contention is the idea that gain must be recognized on any reorganization transfer unless the consideration for such transfer is strictly confined to stock or securities. In effect, so to construe the statute is to impose a tax on nearly all reorganizations. This would amount to an emasculation of the statute, for hardly any such exchange fails to involve an assumption of liabilities, either by express agreement or by requirement of state law. The opposite position is that Congress has exempted any reorganization transfer where stock or securities constitute part of the consideration, except where cash or property in its ordinary legal meaning is received in exchange. Thus the approach to the question becomes all-important, and in view of the declared purpose of

In any event, it may possibly be argued that the reluctance of the Commissioner to go the full distance along his chosen path indicates the unsoundness of the distance he has gone.

³⁴3 C. C. H. 9270, 9272 (1937).

³⁵This method is evidently the one adopted in *Allyne-Zerk Co.*, 29 B. T. A. 1194, C. C. H. Dec. 8434 (1934), although the tax liability was not affected in that instance.

³⁶BAAR & MORRIS, p. 262.

³⁷*Op. cit. supra* note 34, p. 9273.

Congress³⁸ to facilitate business transfers and to avoid hampering them with possibly burdensome taxation,³⁹ the taxpayer would seem to have the better of the argument.

As has already been indicated, statutory or judicial definitions of income have only a somewhat limited bearing upon the reorganization provisions of the Revenue Act. It is well established by *Old Colony Trust Co. v. Commissioner* and *United States v. Boston & Maine R. Co.*⁴⁰ that in cases not within Section 112 (b) a discharge of indebtedness by another, for which there is consideration, represents taxable income. The underlying theory of the decisions is that discharge of the debt sets free assets in the hands of the original obligor which would otherwise be applied to the payment of that debt. The effect of liberating an amount of assets equal to the obligation is the same as actual receipt of cash with which to discharge the debt. The same principle is applied in *United States v. Kirby Lumber Co.*⁴¹ to the purchase by a corporation of its own bonds at less than par. But Section 112 exempts the fruits of certain transactions from taxation unless those fruits are "other property or money." This phrase might well be interpreted to impose an express limitation upon the application of the statutory concept of income despite the rule that exemption provisions are to be strictly construed. For "money" and "property" are words of narrower scope than "income." The very premise of the decisions just cited, was that the taxpayer received neither money nor property but only a bare contract right, and yet a tax was found to accrue. The element of actual receipt is not necessarily a requisite of "income,"⁴² but by the terms of the statute itself it would seem to be essential to the taxability of "other property or money."

III

One more theory by which the Government has attempted to bring assumptions of indebtedness within the phrase "other property or money" remains to be considered. This is the theory of constructive receipt as set forth in

³⁸H. R. REP. No. 179 to accompany H. R. REP. No. 6715, 68th Congress, 1st session. SEN. REP. No. 398, to accompany H. R. REP. No. 6715, 68th Congress, 1st session.

³⁹The legislative history of these provisions of the act will be discussed more fully under the subject of distribution.

⁴⁰*Supra*, note 6.

⁴¹284 U. S. 1, 52 Sup. Ct. 4 (1931); see also *Helvering v. American Chicle Co.*, 291 U. S. 426, 54 Sup. Ct. 460 (1934).

⁴²Secs. 166 and 156 of the Revenue Act, providing for taxation to the grantor of income from certain types of trusts, afford a further illustration. This is especially true of § 167 (a) (3), embracing trusts for the payment of insurance premiums on the life of the grantor, even where no reversionary interest is retained by him. The provision was upheld in *Burnet v. Wells*, 289 U. S. 670, 53 Sup. Ct. 761 (1933). However, it cannot be said that the taxpayer thereunder has received anything whatsoever, not even the possibility of a future contract right. His gain is purely a "flow of satisfaction." For a detailed criticism of this case see Paul and Havens, *Husband and Wife under the Income Tax* (1935) 5 BROOKLYN L. REV. 241.

*The Liquidating Co.*⁴³ case decided by the Board of Tax Appeals in 1936. In that case, a "reorganization plan" was drawn up whereby the company, engaged in the distribution of dairy products, transferred all its assets to the Borden Co., who agreed to give a certain number of its shares of stock in exchange. "All indebtedness and liability whatsoever," including notes of the company and its accounts payable, was assumed by the transferee. In a separate paragraph of the plan, Borden agreed to provide the funds necessary for redemption of the company's convertible debenture bonds on September 1, 1929. These debentures were subject to an option to convert them into common stock, and at the time the plan was approved it was impossible to ascertain to what extent this option would be exercised by the holders of the securities. On August 28, 1929, Borden deposited with the trustee under the indenture the sum required for redemption of all unconverted debentures, and on September 3 *The Liquidating Co.* was dissolved. In computing the company's taxable gain, the Commissioner, as in the *Hendler* case, ignored the assumption of current liabilities but included the amount which had been paid to the debenture holders.⁴⁴

The company contended that the deposit with the trustee was merely a method of discharging a debt already assumed by Borden, and that consequently it was never in receipt of this money. The Board thought otherwise and was at some pains to avoid the question of assumed liability, saying:

"... respondent has not determined that the assumption of petitioner's liabilities by Borden constituted 'other property or money' and so it is immaterial whether petitioner's obligation on its debenture bonds was assumed and afterwards paid, or a contract was made to furnish funds with which to pay that debt. The question whether an assumption of liabilities in such a case constitutes 'other property or money' is not before us. We express no opinion with reference thereto, but confine ourselves to . . . whether the money advanced to pay the debentures did or did not constitute 'money' received by the petitioner and was not distributed within the meaning of section 112 (d) (2)."⁴⁵

Thus the issue is narrowed down to one of the fact—whether or not *The Liquidating Co.* received from Borden, as part of the consideration for the transfer of its assets, money with which to redeem its bonds. The Board decided that it did, citing *Old Colony Trust Co. v. Commissioner* and *United States v. Boston & Maine R. R.*⁴⁶ But it would seem that the further question remains whether such money received for transmission to the debenture holders was or was not in payment of a debt already assumed by Borden; and if it was, whether the assumption of that debt constituted "other property or money."

⁴³33 B. T. A. 1173 (1936).

⁴⁴*Supra* note 33.

⁴⁵*Ibid.* p. 1183.

⁴⁶*Supra* notes 6 and 7.

The Board evidently felt that because the agreement to redeem the debentures was in a separate paragraph of the reorganization plan from the agreement to assume all liabilities and indebtedness, the obligations were distinct and separate; and because they were distinct and separate, they were, therefore, of a distinct and separate nature. In fact, however, the plan probably dealt with the debentures individually because they required special treatment, and the assumption of liabilities "of whatsoever nature" was deemed sufficient to include them in the later paragraph. This is especially true since another separate paragraph relieves Borden from having to assume certain other specified indebtedness. It could thus quite reasonably be contended that the parties regarded the agreement to provide funds for redemption of the debentures as a contract of assumption.⁴⁷ The Board declares that it could not be a contract of assumption because of the conversion feature involved. In other words, because the amount of money to be deposited with the trustee had not yet been ascertained and because it was impossible for Borden to deliver shares of stock of The Liquidating Co. to those who elected to take them, by its very nature the obligation could not have been assumed. But Borden had not attempted to discharge the entire obligation of the bond issue. It had merely agreed to discharge that part of the obligation which was payable in money; in other words, it agreed to redeem those debentures which at a certain date had not been exchanged for stock.

Substantially, therefore, the distinction indicated by the opinion is one of form. If the transferee-corporation agrees to assume a liability, the case falls within the general category of situations involving the interpretation of "other property or money." But if the transferee-corporation agrees to "provide the funds necessary for" the discharge of an indebtedness, the transferor-corporation is in constructive receipt of the money advanced and gain will be recognized. That this distinction is based upon nothing more than the form of the words used in the contract is admitted by the court in *Hendler v. United States*.

The facts in the two cases are essentially similar, with the exception that the agreement by Borden to redeem Hendler's bond issue was included in a clause assuming all Hendler's outstanding liabilities, and with the further exception that this bond issue had no conversion feature. On the question of constructive receipt, the court rests its decision in favor of the taxpayer solely on these differences in facts. Since redemption of the bonds was a debt already ascertainable in amount, and since Borden's obligation to redeem was in form part of one general obligation to assume all of Hendler's liabilities, when the debt was discharged it was, as between transferor and trans-

⁴⁷Even separate agreements are sometimes construed as one; *a fortiori*, separate paragraphs of the same agreement might well be construed together.

feree, the transferee's debt. The opinion had already concluded that a contract of assumption was not "other property or money," so no tax was found to accrue.

Thus, on their reasoning; the decisions in *The Liquidating Co.* and *Hendler v. United States* are not in conflict on this question. But taxation is supposed to be a matter of substance; to tax a recognized gain there should in fact be a gain to recognize. It would seem, then, that this distinction of form is at best a trifle tenuous. From the standpoint of the Treasury, it makes the path to tax avoidance easy; and from the point of view of the taxpayer, it further hampers ordinary business transactions with unnecessary technicalities.

IV

The Liquidating Co. and *Hendler v. United States* are in undoubted conflict as to the meaning of distribution. For even if gain is recognized to the corporation, if such gain is "distributed in pursuance of the plan of reorganization,"⁴⁸ the corporation incurs no tax liability. For proper understanding of this phrase it may be well to bear in mind the avowed purpose of Congress in first enacting the sections of the Revenue Act now under consideration. The report of the House Ways and Means Committee⁴⁹ contains the following paragraph:

"There is no provision of the existing law which corresponds to subdivision (e) of the draft, nor has the Treasury Department ever ruled officially on the type of case covered by that subdivision . . . In other words, if the corporation which sells its assets in connection with the reorganization acts merely as a conduit in passing the proceeds of the sale on to its stockholders, no gain to the corporation is to be recognized, but if it retains all or any of the proceeds with the result that the transaction is in substance a real sale, then all or a part of the gain shall be recognized."

The Senate Finance Committee used the same language,⁵⁰ except that the concluding lines read:

". . . but if it retains the entire amount of the proceeds with the result that the transaction is in substance a real sale, then the gain shall be recognized."

Both Committees adopted almost verbatim the suggestions made by the Secretary of the Treasury on this subject,⁵¹ and it is made abundantly clear that it was intended to tax only such gain as was actually retained by the corporation.

⁴⁸§ 112 (d) (1).

⁴⁹H. R. REP. No. 179, to accompany H. R. REP. No. 6715, 68th Congress, 1st session, p. 15, Feb. 11, 1924.

⁵⁰SEN. REP. No. 398, to accompany H. R. REP. No. 6715, 68th Congress, 1st session p. 16, April 10, 1924.

⁵¹"Statement of the Changes Made in the Revenue Act of 1921 by the Treasury Draft and the Reasons Therefor," published in the New York Times, Jan. 5, 1924.

Nevertheless in *The Liquidating Co.* the Board evidently felt that "distribute" was a word of art, to be applied only to payments in the form of dividends, liquidating or otherwise. Consequently, since the money constructively received had been transmitted to bondholders, and not to stockholders, there was, properly speaking, no distribution. This conclusion was apparently reached solely on the authority of a dictum in *West Texas Refining and Development Co. v. Commissioner*.⁵² It was therein stated that money paid to creditors would not be reflected in the tax returns of individual stockholders, and that hence it would escape taxation entirely if not taxed to the corporation. The court in the *Hendler* case pointed out that so to interpret "distribute" amounted to reading out of the statute the words "in pursuance of the plan of reorganization." This phrase, it held, might well embrace within the meaning of distribution all persons having a stake in the assets of the company,⁵³ whether by way of equitable ownership or creditor's lien. In *Minnesota Tea Co.*,⁵⁴ a majority of the Board declined to extend its decision that a payment to bondholders is not a distribution to a case in which cash received was distributed to stockholders who had assumed the corporation's debts. The doubts cast upon *The Liquidating Co.* opinion were referred to,⁵⁵ but the Board felt that the occasion had not yet arisen expressly to overrule itself. In any event, since reorganization agreements must provide that each class of security holder obtains its due, and inasmuch as it is quite common for creditors to take equities in the transferee company in discharge of their claims, it does not seem to do violence to the statute to interpret a distribution "in pursuance of the plan" widely enough to include bondholders.

The Commissioner contended that Congress had expressly limited "distribution" to stockholders in Sections 112 (g) and 115, and that, therefore, such limitation was to be assumed in Section 112 (d). To this the court remarked that the argument cuts both ways. In the former sections the limitation is required by the subject matter—taxation of individual stockholders—and so its omission in Section 112 (d) is perhaps significant. However, it would seem possible in any case to argue a constructive distribution to stockholders of a contract to assume the liabilities of a corporation which is about to dissolve. Upon the consummation of the reorganization exchange, nothing remains to the transferor but the consideration received for the transfer of its assets. If it then proceeds to distribute to its stockholders

⁵²68 F. (2d) 77 (C. C. A. 10th 1933).

⁵³Where money received was used to redeem outstanding preferred stock the redemption has been held to be a distribution; G. C. M. 3827, VII-2 CB 114.

⁵⁴34 B. T. A. 145 (1936). This case has recently been reversed in C. C. H., vol. 4, 1937, p. 9780 (C. C. A. 8th 1937). The opinion in *Hendler v. United States*, *op. cit. supra* note 34, was not referred to.

⁵⁵See especially 2 PAUL AND MERTENS, LAW OF FEDERAL INCOME TAXATION §§ 17.97-17.102.

all cash and securities it has acquired, creditors may presumably, in the absence of a contract of assumption, look to the distributees for discharge of any outstanding liabilities. But if the transferee corporation has assumed those liabilities, the stockholders are protected against any claim of creditors and may retain the full benefit of the cash and securities distributed to them. Thus, it is the stockholders who upon dissolution receive the benefit of the contract of assumption. It can be argued that the contract is the equivalent of money to the corporation, or that the corporation is in constructive receipt of money; if this argument is sound, it logically follows that when the corporation ceases to exist, its distributees have acquired the equivalent of, or are in constructive receipt of, the money which the contract is supposed to represent.⁵⁶

On the other hand, as pointed out by Baar and Morris,⁵⁷ if the transferor corporation does not dissolve but retains in its hands enough assets to meet all liabilities and distributes to stockholders all money and securities received from a reorganization exchange, the situation is a different one. Where there is no contract of assumption, creditors can have full recourse against the corporation, the liabilities of which are in no danger of being imposed upon its stockholders. Therefore, the transferor retains the benefit of the consideration received; and if gain is recognized, it should be recognized to the corporation.

This theory would seem to be in accord with the House and Senate reports; for if the corporation dissolves it is in effect acting "merely as a conduit" in passing on the benefit of the contract to its stockholders. With regard to the general purpose of the statute, the opinion in the *Hendler* case declares:

" . . . [it is to] remove from ordinary business transactions the deterrent influence of immediate and possibly onerous taxation on merely paper profits. Obviously taxation to the corporation of money received by it and disbursed in payment of debts . . . would tend to frustrate this intent of the statute. . . . The net gain to the corporation is not marked by money paid by it to creditors, but by what it retains or distributes to stockholders, and in the latter case they become ultimately liable to proper taxation on actually realized gain."⁵⁸

A simple illustration will suffice to show in what direction the Government contention is pointing. In the case of *George Whittell and Co.*,⁵⁹ a California corporation in order to avoid a California excise tax transferred all its assets to a Nevada corporation formed for the purpose of acquiring them. When the reorganization was entirely completed, the transferee had the

⁵⁶This argument was implied but not expressed in *National Pipe & Foundry Co.* 19 B. T. A. 242 (1930).

⁵⁷*Ibid.* p. 268.

⁵⁸*Op. cit. supra* note 34, p. 9277.

⁵⁹34 B. T. A. 1070 (1936).

same capitalization, assets, liabilities, officers, and stockholders as its transferor.⁶⁰ It would be difficult in this situation to find any gain upon which to impose a tax; but if the fair market value of the shares of the new company were greater than the old book value of the transferred assets, there would be a paper profit. To tax this profit, simply because the liabilities of the old corporation were assumed by the new, is apparently just what the statute tries to avoid. Where the transferee corporation has a greater capitalization than its transferor, the value of the equity is still increased only on paper, so the same reasoning applies. In short, whatever merit there may be in the Government's argument that an assumption of liability constitutes "other property or money," it seems in clear contravention of both the wording and the purpose of the Revenue Act to hold that the consideration which such assumption represents is taxable to the corporation because not distributed.

⁶⁰The question of "other property or money" was not considered by the Board.