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Unexpected Disqualification of Reorganizations Under the Internal Revenue Code by the Inadvertent Transfer of Boot

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I. Introduction

It is common today to read of corporations "merging" or of one corporation "buying out" another.[1] Many of these transactions will be "reorganizations"[2] under section 368(a) of the Internal Revenue Code. Section 368 is the current congressional resolution of two conflicting policies of tax law. On the one hand, it is desirable to promote the free mobility of capital in order that it be used in the most economical manner. On the other hand, there is the desire to prevent shareholders from using corporate reorganizations as a means of avoiding income taxes. The most common of shareholder schemes

1. The terms "merging" and "buying out" are often used by laymen to indicate one of several possible transactions; for example, a cash sale, a stock swap, a swap of stock for property or a statutory merger. An example of the lack of uniformity in the use of these terms even between businessmen themselves is found in the February 17, 1965 issue of the *Wall Street Journal.* On page 20, column 2, there is a discussion of the proposed "merger" of Pure Oil Company and Union Oil Company. On page 11, column 1, there is a discussion of United Utilities' plan to "purchase" Mansfield Telephone Co. Both transactions involved the exchange of stock for stock. In a technical sense they involve neither mergers or purchases, but constitute § "B" reorganizations under the Code. See part III for a more thorough discussion of a § "B" reorganization. Henceforth, this writer will use the term merger or statutory merger in the strict sense of § 368(a)(1)(A) of the Int. Rev. Code of 1954 [hereinafter cited as Code]. A merger is a "union of two or more corporations by the transfer of property of all to one of them, which continues in existence, the others being swallowed up or merged therein . . . It differs from a consolidation where all the corporations terminate their existence and become parties to a new one. . . ." Black, Law Dictionary (4th ed. 1951). The term practical merger or non-statutory merger will be used to indicate a stock swap or an exchange of stock for property (see Part III for a more complete explanation). The term corporate combination or corporate affiliation will be used to include any of the above transactions.

2. It is important to understand that the term "reorganization" is a term of art. It does not connote what a layman considers to be a reorganization. Code § 368(a) defines it thus:

"(a) Reorganization.—

(1) In General.—For purposes of parts I and II and this part, the term "reorganization" means—(A) a statutory merger or consolidation; (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition); (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded . . . ."

are those which attempt, through these reorganizations, to distribute corporate earnings without the payment of dividends that would otherwise be subject to the ordinary income tax.[3]

If a transaction is a reorganization, it will be completely or partially tax free to both the shareholders and the corporations involved.[4] It may be surprising, but it is possible for a multi-million dollar corporate consolidation to be disqualified as a reorganization with disastrous tax consequences simply because a thirty dollar item was handled improperly. This and analogous situations, however, will be considered below. In a section 368 (a)(1)(B) or 368 (a)(1)(C)[5] reorganization, there is the requirement that the acquisition be "solely" for voting stock. The purpose of this article is to enumerate and discuss the features of intended "B" and "C" reorganizations that may violate the "solely" requirement with resulting unexpected and undesired tax consequences.

In planning a corporate reorganization, it is important that the attorney be aware of the dangers of poor planning. This is true even where the attorney plans to obtain an advance ruling[6] on the proposed reorganization. Recognizing the dangers in advance makes it possible to obtain an advance ruling with a minimum of inconvenience. Furthermore, disqualification of a reorganization is possible even where an advance ruling has been obtained,[7] thus, making it doubly important to exercise caution.

II. Reasons for and Importance of Corporate Combinations[8]

While it would be impossible to enumerate or ascertain all of the reasons for the combining of corporations, it may be helpful to mention a few. The owners of the acquiring corporation[9] may desire to expand, to increase earnings, to diversify, to establish a nation-wide business, or to strengthen the competitive position of the corporation. On the other hand, the owners of the acquired corporation[10] may desire to

3. See Treas. Reg. § 1.368-1(b) (1955).
4. See part III *infra* for a more thorough discussion of the tax consequences.
5. Hereinafter called a § "B" or § "C" reorganization. Part III *infra* describes a "B" or "C" reorganization.
6. 26 C.F.R. § 601.201(a)(1) (Supp. 1963) (rulings).
7. *Ibid.* For example, where insufficient or incorrect facts have been submitted by the taxpayer.
8. See note 1 *supra* for what is meant by a "combining."
9. The acquiring corporation in a merger is the one that survives; in a stock swap it is the corporation that becomes the parent—that is, it controls the other corporation; in an exchange of stock for property, it is the corporation that receives the property. See part III *infra.*
10. The acquired corporation disappears in a merger. It becomes a subsidiary corporation in a stock swap. In an exchange of property for stock, it may or may not be liquidated depending on the circumstances. See part III *infra.*

sell out[11] to make a profit, to keep from becoming bankrupt, to establish a valuation of the business for estate tax purposes, or to retire.

Many of our corporate giants, U.S. Steel, for example, were formed from a combination of several corporations. There are thousands of statutory and non-statutory mergers each year in the United States. The ability freely to transfer and combine capital is one of the major causes for the success of the free enterprise system.[12]

III. METHODS OF COMBINING CORPORATIONS

A. *Cash Sale*

The most obvious and perhaps easiest method of combining is for the acquiring corporation to buy the assets of another corporation, or to buy the shares of the corporation from the shareholders for cash. The greatest disadvantage of a cash sale is that tax liability will likely be incurred. This tax may be a capital gains tax imposed on either the corporation or the shareholders, a "double" capital gains tax,[13] or an ordinary income tax with rates up to seventy per cent.[14] The possible imposition of tax liability is a basic reason for the widespread use of the "reorganization" type of combination rather than the cash sale transaction.

Section 368(a)[15] defines the different types of reorganizations. If a transaction is a reorganization[16] under section 368(a), the tax con-

11. "Sell out" means any method of disposition of a corporation, *i.e.*, merger, cash sale, etc. See part III *infra* for a fuller explanation.

12. As a result of the passage of the anti-trust laws—Sherman Act, 26 Stat. 209 (1890), *as amended*, 15 U.S.C. § 1 (1958); Clayton Act, 64 Stat. 1125 (1950), 15 U.S.C. § 12 (1958)—and of the recent strict enforcement of such laws, the use of statutory and non-statutory mergers by large corporations has been somewhat restricted. However, as the competitive advantage of being a large corporation (in this age of automation) becomes more apparent, it is likely that smaller corporations will increasingly consolidate so that they will become a "giant" or at least so they will become large enough to be able to compete with the "giants." For illustration, see KEFAUVER, IN A FEW HANDS ch. 4 (1965).

13. By a "double" tax the writer has made reference to a tax at the corporate level and another tax at the shareholder level. See Commissioner v. Court Holding Co., 324 U.S. 331 (1945) and § 337 of the 1954 CODE which at least partially solve this problem.

14. However, a tax at ordinary income rates is not likely. Since this note is not concerned with this problem, there will be no further discussion as to which of these taxes is applicable in a particular situation.

15. *Supra* note 2.

16. There was at one time a dispute as to whether or not a transaction could be a reorganization and not fall within the strict definitions of § 368(a) of the Code. However, in Turnbow v. Commissioner, 368 U.S. 337 (1961), it was definitely established that no such transaction could be a reorganization. *Turnbow* involved a § "B" reorganization, but the same is true as to a § "C" reorganizatien. See 16 ABA BULL. OF SECT. OF TAX, No. 1, 42 (Oct., 1962).

sequences will probably be more favorable than a cash sale.[17] This article is concerned only with section 368 "A," "B" and "C" reorganizations, the combining type of reorganizations.[18]

B. *Reorganizations*

1. *"A" Reorganizations.*—An "A" reorganization is a statutory merger or consolidation under an applicable statute of a state, territory or the District of Columbia.[19] In order to determine the requirements for an "A" reorganization it is necessary only to follow the appropriate statute. To the extent stock or securities are exchanged for stock or securities[20] or to the extent stock or securities are exchanged for property,[21] no gain or loss is recognized in the merger or consolidation. However, if "boot" is received, then gain is recognized to the extent of the boot.[22] Although the term "boot" is not found in the code, it is an important concept in a section "A" reorganization.[23]

2. *"B" Reorganizations.*—A "B" reorganization is the acquisition of the stock of a corporation in exchange *solely* for the voting stock of the acquiring corporation.[24] The acquired corporation does not lose its identity, but becomes a subsidiary of the acquiring corporation.[25] The acquiring corporation must have control of the acquired corporation immediately after the acquisition. Section 368(c) defines "control" to mean at least eighty per cent ownership of voting stock and at least eighty per cent ownership of all other classes of stock. There must be no consideration exchanged other than stock.[26] If the transaction qualifies as a "B" reorganization, then no gain or loss will

17. The tax consequences are discussed later in this part.
18. There will be no discussion of a § 368(a)(1)(E) reorganization (a recapitalization or a § 368(a)(1)(F) reorganization (a mere change in identity, form, or place of organization).
19. See CODE § 368(a)(1)(A) *supra* note 2. For examples see N.J. REV. STAT. §§ 14:12-1 to -10 (Supp. 1964); N.Y. STOCK CORP. LAW § 85; TENN. CODE ANN. §§ 48-517 to -522 (1965).
20. CODE § 354. However, if debt securities are received in greater principal amount than the debt securities given up, then the excess is taxable as boot under § 354(a)(2).
21. CODE § 361.
22. CODE § 356. However, no loss is recognized. If the Corporation has earnings and profits, it is likely that boot will be treated as a dividend. See note 23 *infra.*
23. See 3 MERTENS, LAW OF FEDERAL INCOME TAXATION § 20.147 (1957), for a thorough discussion of boot. Section 356(a)(2) provides that boot will be taxed as a dividend to the extent of undistributed earnings and profits, if the exchange has the effect of the distribution of a dividend. Otherwise, boot will be treated as gain from the exchange of property. See Commissioner v. Bedford's Estate, 325 U.S. 283 (1945); Idaho Power Co. v. United States, 161 F. Supp. 807, (Ct. Cl. 1958).
24. CODE § 368(a)(1)(B); see note 2 *supra.*
25. The subsidiary may later be liquidated under § 332 of the Code.
26. See Turnbow v. Commissioner, *supra* note 16.

be recognized by the shareholders.[27] As indicated above,[28] if any consideration passes other than voting stock, the transaction will not qualify as a reorganization and gain[29] will be recognized.

3. *"C" Reorganizations.*—A "C" reorganization is the acquisition of substantially all the *property* of a corporation in exchange solely for voting stock of the acquiring corporation.[30] Section 368(a)(2)(B) softens somewhat the *solely* requirement in a "C" reorganization. Consideration other than voting stock may be exchanged under certain conditions. As much as twenty per cent of the assets of the acquired corporation may be obtained for cash if the remaining eighty per cent is obtained solely for voting stock. The assumption of liabilities is treated in the same manner as payment of money in determining whether eighty per cent of property is acquired for voting stock. If the transaction is a "C" reorganization under section 361, with the exception of section 354 debt securities, no gain or loss is recognized to the extent of the securities exchanged.[31] However, there will be gain recognized to the extent of the boot.[32]

In addition to the requirements stated in section 368(a), the courts have laid down other requirements which must be satisfied.

The first court decisional requirement is the "business purpose doctrine."[33] There must be a valid business purpose in the reorganization. Second, there must be a "continuity of proprietary interest,"[34] that is, the acquired corporation shareholders must have a continuing interest in the reorganized corporation. Since this requirement is automatically met in the definition of a "B" or "C" reorganization, the common law doctrine applies only to an "A" reorganization. Third, the "Step Transaction Doctrine":[35] if a corporation could accomplish in one

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27. Code § 354.

28. *Supra* note 16.

29. Ordinarily this would be a long term capital gain under § 1201(b) of the Code. Turnbow v. Commissioner, *supra* note 16, decided that there can not be a reorganization unless the definitions of § 368(a) are followed. Sections 354 and 356(a)(2), apply only to § 368(a) reorganizations. Thus, if an attempted "B" reorganization were disqualified, it would not be possible to tax the boot as a dividend under § 356(a)(2).

30. Code § 368(a)(1)(C). See note 2 *supra.*

31. If a transaetion meets the statutory description of both § "C" and § "D" types, then § 368(a)(2)(A) provides that the transaction shall be treated as a § "D" reorganization.

32. Code § 361. *Supra* note 23.

33. See Cregory v. Helvering, 293 U.S. 465 (1935); Cogan v. Commissioner, 97 F.2d 996 (2d Cir. 1938).

34. See Courtland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932); Treas. Reg. § 1.368-1(b) (1954).

35. See Mentz & Plumb, *Step Transactions in Corporate Reorganization,* N.Y.U. 17th Inst. on Fed. Tax 247 (1954).

transaction what it accomplished in two or more transactions except for adverse tax consequences, then the two steps will be considered as one.

IV. A Comparison of the Advantages of the Three Types of Reorganizations

A. *Advantages of An "A" Reorganization*

The primary advantage of an "A" reorganization, a statutory merger or consolidation, is the flexibility of the consideration that may be transferred. Section 368 imposes no limit as to what consideration may be used. Naturally, gain will be recognized to the extent that boot is actually transferred.[36] In a "B" reorganization, the only consideration allowed is voting stock and in a "C" reorganization the use of boot is limited.[37] The writer believes there is another related advantage that has not been sufficiently appreciated. As indicated below,[38] many attempted "B" and "C" reorganizations have failed because boot was received almost inadvertently. In many situations, especially where an advance ruling[39] is not obtained, the attorney would be wise to consider an "A" reorganization in order to avoid falling into a tax trap.

B. *Advantages of A "B" Reorganization*

A "B" reorganization, in which the stock of a corporation is exchanged solely for the voting stock of the acquiring corporation, has several important advantages over an "A" reorganization. In an "A" reorganization, state statutes normally require the consent of two thirds of the shareholders of both corporations,[40] whereas in a "B" reorganization, assuming that there is sufficient authorized but unissued stock free of preemptive rights, no formal shareholder consent is required in either corporation.[41] Of course, enough shareholders of the acquired corporation must exchange their shares so that the acquiring corporation obtains "control," which is eighty per cent of ownership.[42] Thus, there will be at least eighty per cent informal consent. Another major advantage involves the right of shareholders to have their shares appraised and to be paid cash at the appraised value. Many corporate

36. Code § 356.
37. See Code § 368(a)(2)(B) and part III *supra.*
38. Part VI through IX *infra.*
39. *Supra* note 6.
40. N.J. Rev. Stat. § 14:12-3 (1937), requires two-thirds shareholder consent. N.Y. Stock Corp. Law § 85, also requires two-thirds shareholder consent. Tenn. Code Ann. § 48-502 (1955), requires only majority shareholder consent.
41. See note 44 *infra.*
42. Code § 368(c).

affiliations would never be consummated if it were necessary to pay off dissenting shareholders since such transactions require a large cash outlay. Most state statutes[43] require such appraisal rights in "A" reorganizations.[44] In a "B" reorganization, the shareholders of the acquired corporation have no rights of appraisal since there is no corporate action; the approving shareholders simply swap stock. There ordinarily would not be any appraisal rights granted the shareholders of the acquiring corporation since appraisal statutes apply only to "A" reorganizations.[45] However, see *Farris v. Glen Alden*,[46] for a contrary decision. This case involved an attempted "B" reorganization with a later liquidation of the subsidiary.[47] Although the transaction was quite unusual, which probably accounts for the result, the case has provoked considerable discussion among corporation lawyers. The reorganization was designed in terms of the Glen Alden corporation acquiring the List corporation assets, whereas in actuality the present shareholders of List would control the new corporation. The Pennsylvania Supreme Court held that although the transaction was not technically a statutory merger,[48] in reality it was, and that appraisal rights must be granted.[49]

A "B" reorganization may be preferred over an "A" because of the manner in which the applicable state statute is drawn. If the statute is poorly drawn and difficult to use, it would often be wise to avoid the use of the statute. For example, where the two corporations that are to be affiliated are incorporated in different states, some state statutes makes it more difficult for the corporations to merge than if both corporations were incorporated in the same state.[50]

A "B" reorganization would have an advantage over a "C" reorganization where there is a desire to retain the corporate identity of the acquired corporation, for example, where there are favorable contracts in existence, or where it would be helpful in retaining skillful management.

A "B" reorganization should be used where the corporation being

43. Examples of typical statutes are: N.J. REV. STAT. § 14:12-7 (Supp. 1964); N.Y. STOCK CORP. LAW § 97; TENN. CODE ANN. § 48-503 (1955).

44. See Darrell, *The Use of Reorganization Techniques In Corporate Acquisitions*, 70 HARV. L. REV. 1183, 1193 (1957); Johnson, *Reorganizations—Minority Stockholders, Including Dissenters*, N.Y.U. 18TH INST. ON FED. TAX 821 (1960); *The Right of Shareholders Dissenting From Corporate Combinations to Demand Cash Payment for Their Shares*, 72 HARV. L. REV. 1132 (1958).

45. *Supra* note 44.

46. 393 Pa. 427, 143 A.2d 25 (1958).

47. CODE § 332.

48. PA. STAT. ANN. tit. 53, § 421 (1958).

49. Allowance of appraisal right killed the proposed transaction because of the resultant cash drain.

50. See N.J. REV. STAT. 14:15-10 (1937).

acquired has a tax loss carry-over and shareholders of the acquired corporation as a group will not own twenty per cent of the acquiring corporation after the transaction. In order to take full advantage of a tax loss in an "A" or "C" reorganization, section 382(b) requires that the acquired corporation shareholders as a group must, immediately after the reorganization, have a twenty per cent ownership in the acquiring corporation. Section 382(b) does not apply to "B" reorganizations.

C. *Advantages of A "C" Reorganization*

It was noted above that in an "A" reorganization there are requirements for shareholder consent and minority appraisal rights. Consent of shareholders of the acquiring corporation is not necessary in a "C" reorganization assuming that authorized but unissued stock free of preemptive rights is available.[51] However, consent of the shareholders of the acquired corporation is normally required since sale of corporate assets is a major corporate change.[52] As to appraisal rights, the shareholders of the acquiring corporation have no such rights.[53] Moreover, a majority of the states allow appraisal rights to the shareholders in a "C" reorganization of the acquired corporation.[54]

A "C" reorganization also has several advantages over a "B" reorganization. The primary advantage is the flexibility of the consideration allowed. A limited amount of boot may be used and assumption of liabilities is allowed in a "C" reorganization.[55] The consideration in a "B" reorganization must be voting stock. As later shown,[56] the *solely* requirement in a "B" reorganization is so strictly enforced that many "B" reorganizations are disqualified on trivial technical grounds. Another advantage of a "C" reorganization is that, since a corporation itself is not acquired, *i.e.*, only property is obtained, there is no problem of a minority shareholder interest in the transferor corporation having disputes with the acquiring corporation. Related to this is the fact that an exchange resulting in the acquisition of only property may mean that the acquiring corporation is free from concern with liabilities of the transferor corporation, that is, the transferor corporation is left with the responsibility for its own liabilities.[57]

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51. See authorities cited note 44 *supra*.
52. *Ibid.*
53. *Ibid.*
54. *Ibid.*
55. CODE § 368(a)(2)(B).
56. See parts VI through IX *infra*.
57. The transferee corporation may also be liable by contract or by action of law. *i.e.*, if there was a fraudulent conveyance.

V. An Example of Inadvertent Disqualification

A. *Mills v. Commissioner*

In the *Mills* case,[58] plaintiffs were three brothers who owned equal shares in three gas corporations. Pursuant to a "B" reorganization the brothers exchanged shares in the three gas companies for shares of General Gas Corporation whose shares were valued at fourteen dollars each. The plan also "provided that in the event the purchase price is not evenly divisible by shares at Fourteen Dollars ($14) per share, the difference will be paid in cash."[59] Because the purchase price was not evenly divisible, each plaintiff received twenty-seven dollars and thirty-six cents in cash in addition to shares of stock in the General Gas Corporation. The Commissioner determined that the transaction was not a "B" reorganization since the consideration was other than voting stock because twenty-seven dollars and thirty-six cents had exchanged hands. Thus, the Commissioner found that there was a long term capital gain and determined a deficiency. On appeal, the Tax Court en banc approved the Commissioner's findings.[60] Petitioners appealed to the Court of Appeals for the Fifth Circuit where the tax court decision was overturned.[61] Although the taxpayers prevailed, after two trials and ten years, the court was careful to distinguish prior authority. The court stated that there was simply a mathematical rounding off of a fractional share and that the cash payment did not represent additional consideration. The court distinguished the case from a situation where a small amount of cash is bargained for as an independent part of the consideration. In effect, the court states that an agreement to exchange stock plus one dollar would disqualify a "B" reorganization. The Court was not willing to decide whether the rule *de minimius non curat lex* (the law does not care for, or take notice of, very small or trifling matters)[62] applied. Thus, it appears that, in a "B" reorganization, the *solely* requirement means that if any consideration other than voting stock is exchanged, no matter how triffling, the transaction cannot be a "B" reorganization.[63]

It is suggested that when an attorney is faced with the fractional share problem of the *Mills* case he should handle the fractional shares

58. 331 F.2d 321 (5th Cir. 1964).

59. *Ibid.*

60. Mills, 39 T.C. 393 (1962).

61. Mills v. Commissioner, *supra* note 58.

62. For authority that the *de minimis* rule applies to § "B" reorganizations, see 3 Mertens, *op. cit. supra* § 20.89, at 324.

63. The same general principle holds true for a "C" reorganization, but as noted above in part III *supra*, there may be a limited consideration other than voting stock under certain conditions. The receipt of a fractional interest itself or the distribution of script in lieu of fractional shares is not boot. See Rev. Rul. 55-59, 1955-1 Cum. Bull. 35.

in the following manner. Cash should not be distributed in lieu of the fractional share. Instead, the fractional share can be distributed itself. The receiving shareholder can then buy an additional fraction to make a whole share or sell the fractional share. The transaction can be handled by an independent transfer agent or by the acquiring corporation itself.[64] That the Commissioner will allow the acquiring corporation to sell the fractional share for the transfer shareholder and then pay him the proceeds, but will attack any transaction where the acquiring corporation simply distributes cash in lieu of fractional shares indicates the ridiculous extent to which the Commissioner will allow form to rule over substance in these transactions. It is obvious, therefore, that this rule constitutes a trap into which the unforewarned taxpayer may inadvertently step.[65]

VI. Miscellaneous Expenditures That May Constitute Boot

A. *Payment of Reorganization Expenses*

It is unsettled whether the payment of reorganization expenses of the acquired corporation, such as legal fees, accounting fees, and printing costs, by the acquiring corporation would constitute boot. The Revenue Service takes the position that such payments are boot.[66] This boot would disqualify an attempted "B" reorganization and perhaps a "C" reorganization if twenty per cent leeway was violated. There is also a dictum by a Court of Appeals taking the same position.[67] However, the Tax Court has taken the position in several cases that such payments are not boot.[68] These cases, however, involved insolvency reorganizations where the only source of payment was the acquiring corporation. In general, it would appear to be unwise to let the acquiring corporation pay reorganization expenses of the acquired corporation. It is, however, possible to reach a more definite conclusion in reference to certain expense items. The Service has ruled that payment of the documentary stamp tax by the acquiring corporation will not lead to disqualification, the rationale being that the

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64. *Supra* note 58, at 324; Rubenfield, *infra* note 66, at 67.

65. It must be remembered that there is a qualification to the *"solely"* requirement in a § "C" reorganization by § 368(a)(2)(B). Thus, when there is a reference to non-qualifying consideration it refers to consideration other than the 20% leeway allowed in a § "C" reorganization.

66. 17 ABA Section of Taxation Bull. No. 2, 53 (Jan. 1964); Rubenfeld, *Handle Expenses, Fractional Shares, Escrows, in Reorganizations with Great Care,* 14 J. Taxation 66 (1961), for a discussion of the techniques that have been developed to handle this problem.

67. Stockton Harbor Industrial Co. v. Commissioner, 216 F.2d 638 (9th Cir. 1954).

68. Peabody Hotel Co., 7 T.C. 600 (1946), *acq.*, Roosevelt Hotel Co., 13 T.C. 399 (1949).

acquiring corporation is also liable for the payment of the stamp tax.[69] In some reorganizations, the shareholders of the acquired corporation, desiring to trade freely their shares in the acquiring corporation, may require the acquiring corporation to register the acquired stock,[70] or registration may be required as a public offering.[71] Although the point is not clear, apparently the Revenue Service will not consider such an agreement or payment of registration expenses as additional consideration.[72] A transfer agent is ordinarily used to handle both the exchange of full shares and the issuance and later disposal of fractional shares. It is an unresolved question whether the payment of the transfer agent's fee by the acquiring corporation would constitute boot. The Revenue Service has apparently allowed such payments in some private rulings.[73] Sometimes a reorganization is accomplished as a result of a middle-man who charges a finders fee. Although there is no known authority, it is presumed that if the acquiring corporation paid the finders for the acquired corporation, the payment would constitute boot and lead to a possible disqualification.[74]

Tax considerations aside, which party to a reorganization would normally pay the above expenses? The answer in any particular transaction turns on the particular facts of that case. It should be noted, however, that in a "B" reorganization the parties on one side of the transaction are shareholders who ordinarily would be less able to pay reorganization expenses than would be the acquiring corporation. Normally these shareholders might expect the acquiring corporation to pay their expenses. As shown above, this could disqualify an attempted reorganization.

As seen above, the Internal Revenue Service takes a strict view as to what is boot when the question concerns reorganization expenses. With the exception of the payment of the stamp tax, it would be dangerous to pay any reorganization expenses that could be attributed to the acquired corporation or its shareholders.

VII. CONTRACT PROVISIONS OF A PROPOSED REORGANIZATION THAT MAY CAUSE A DISQUALIFICATION OF THE PLAN

A. *Use of Stock Options*

Frequently in reorganizations there is a need to use stock options

69. 17 A.B.A., BULL. OF SECT. OF TAX No. 1, 81 (Oct. 1963).

70. Securities Act of 1933, 48 Stat. 74 (1933), *as amended*, 15 U.S.C. §§ 77a-77aa (1958), *as amended*, 78 Stat. 565 (1964), 15 U.S.C.A. 78(c) (Supp. 1964).

71. See SEC Rule 133, C.F.R. § 230.133 (1964); 1 Loss, SECURITIES REGULATION 518-42 (2d ed. 1961).

72. Freling, *Tax Consequences of Nontax Motivated Aspects and Factors in the Sale of a Corporate Business*, N.Y.U. 21ST INST. ON FED. TAX 1107, 1114 (1963).

73. See Darrell, *supra* note 44, at 1193.

74. Freling, *supra* note 72.

with or without the issuance of warrants. For example, the acquiring corporation may desire an option to acquire the shares of the minority shareholders of the acquired corporation and/or the same minority shareholders may desire the right to have the acquiring corporation purchase their shares. The Regulations provide that rights to buy stock (whether voting or non-voting) or warrants are not stock or securities within the meaning of section 354.[75] Thus, if such options or warrants were granted in a "B" or "C" reorganization, the "solely," requirement would be violated leading to possible adverse tax consequences.[76]

B. *Escrow of Stock*

In a "B" or "C" reorganization the transferee is often required to place a portion of the stock received from the transferor in escrow to satisfy any liabilities that may arise. The escrow itself does not effect the reorganization.[77] However, if dividends are retained in escrow and an amount is paid to the sellers in lieu of dividends (but equal to the amount of the dividends) after the termination of the escrow, then one author has said that the Treasury might consider such a payment boot and disqualify the "B" or "C" reorganization.[78] This author, however, believes that such a payment would not constitute boot. The Treasury's argument would be stronger if some interest had been earned on the dividends left in escrow since the total payout would exceed the dividends.

C. *Certificates of Contingent Interests*

Certificates of contingent interest are often used to serve the same purpose as an escrow of stock, that is, as protection for the acquiring corporation from contingent liabilities of the acquired corporation in a statutory or non-statutory merger. The certificate represents a fractional share of, or interest in, the stock of the acquiring corporation.[79] The actual fractional share due the shareholder is not determined until the liabilities to be protected against, if any, are determined and settled. Ordinarily, this certificate is distributed to the shareholders of the acquired corporation at the same time the shares of the

75. Treas. Reg. § 1.354-1(e) (1955).
76. Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942); Darrell, *supra* note 44, at 1211.
77. McAbee, 5 T.C. 1130 (1945), *acq.*, 1946-2 CUM. BULL. 4.
78. Rubenfeld, *supra* note 66, at 67.
79. Carlburg v. United States, 281 F.2d 507 (8th Cir. 1960).

acquiring corporation are distributed. Section 368(a)(1)(B) and 368(a)(1)(C) require the exchange to be one solely for "voting" stock. If certificates of contingent interest are not considered to be voting stock, the *solely* requirement is violated. In an "A" reorganization the Treasury has ruled that certificates of contingent interest constitute boot.[80] If this same reasoning should be applied to a "B" or "C" reorganization, there is the danger of disqualification.

There is, however, the case of *Carlberg v. United States*,[81] holding contra. The reorganization in *Carlberg* involved an "A" merger. Negotiable certificates of contingent interest were issued to the shareholders of the disappearing corporation. They were issued to take into account potential, but unknown, tax liabilities of the disappearing corporation. The Court of Appeals for the Eighth Circuit determined that the certificates of contingent interest were received as part of the tax free exchange.[82] The *Carlberg* case held only that the certificates of contingent interest should be treated as stock. In a "B" or "C" reorganization, however, in order that the certificates of contingent interest will not be treated as boot, they must be treated as *voting* stock. Furthermore, the Revenue Service has apparently made no announcement as to whether it will follow the *Carlberg* case. It would appear, therefore, that the Commissioner in either a "B" or "C" reorganization would rule that negotiable certificates of contingent interest are boot. Apparently, the Revenue Service is willing to treat an exchange as one solely for stock if the conditional rights to receive additional stock are represented only by a contractual obligation and not by negotiable certificates.[83] Therefore, in order to avoid the danger, certificates of contingent interest should not be used. Instead, the acquiring corporation should agree by contract to issue additional shares or a fraction of a share after the contingent liabilities are determined.[84]

D. *Intent of the Parties*

In a close case, the fact that the parties in some way had manifested that they were making a "sale" might be sufficient to result in an adverse holding. In the *Mills* case, three tax court judges held against the taxpayer because petitioners originally considered the transaction

80. Rev. Rul. 57-586, 1957-2 Cum. Bull. 249.
81. *Supra* note 79.
82. *Ibid.*
83. Horrow, *Recent Developments in Corporate Reorganizations*, 15 U. So. Cal. 1963 Tax Inst. 251, 287. Mr. Horrow did not cite any authority to support this conclusion.
84. Carlberg v. United States, *supra* note 63.

as a purchase and sale.[85] Thus, it could be important in considering a proposed corporation consolidation not to speak in terms of a possible sale.

VIII. Contract Provisions Having To Do With the Future Employment of the Acquired Corporation's Shareholders

A. *Covenant Not To Compete*

In a corporate combination, the acquiring corporation would often like to have a guarantee that it will not be faced with competition from the acquired corporation's shareholders. In many corporate affiliations, a "covenant not to compete" is used to obtain this guarantee. It would appear that cash payments paid under a reasonable covenant not to compete would not constitute boot, that is, the contract would be treated separately. However, if the payments are unreasonably high or otherwise evidently attributable to something extra being given to the shareholder in connection with the transfer of his stock, then boot is present leading to a possible disqualification.[86]

B. *Attractive Employment Contract*

If the controlling stockholder of the acquired corporation is given an unreasonably attractive employment contract with the acquiring corporation, then in effect, he is probably being given additional disguised consideration for his stock, and the Revenue Service is likely to determine that boot was transferred.[87] A more difficult and unresolved question is whether or not any employment contract could be considered an additional inducement to the shareholder of the acquired corporation for making the stock swap, thus constituting a violation of the *solely* requirement. This writer believes that a reasonable employment contract should not violate the *solely* requirement. The services of the controlling shareholder of the acquired corporation would often be quite valuable to the acquiring corporation.

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85. Mills, *supra* note 60.

86. Freling, *supra* note 72, at 1162. In a covenant not to compete, usually the payments made to the shareholder are taxable as ordinary income. See Hamlin's Trust v. Commissioner, 209 F.2d 761 (10th Cir. 1954). On the other hand, the acquiring corporation may often write off the payments over the life of the covenant as a depricable asset. See Commissioner v. Gazette Tel. Co., 209 F.2d 926 (10th Cir. 1954); 3B Mertens, Law of Federal Income Taxation § 22.33 (1958); *Covenants Not to Compete,* 31 Tenn. L. Rev. 450 (1963).

87. Freling, *supra* note 72, at 1160.

IX. Two or More Transactions Treated as One—Disqualification[88]

These transactions are often complex and disqualification may result even when attorneys with some expertise in the tax field are involved. The transactions seem to fall into two basic types.

A. *Transfer Not Solely in Exchange For Stock*

The first type is where there is a receipt by the acquired corporation of its own shares making the transfer one not solely in exchange for stock of the acquiring corporation.

In *Bausch & Lomb Optical Co. v. Commissioner*,[89] the plaintiff owned 79.9 per cent of Riggs Optical Company. There was an attempted "C" reorganization, Bausch Optical exchanging its shares for all of Riggs Optical assets. Riggs was then dissolved by transferring its only asset, Bausch Optical stock, to its shareholders, receiving in exchange its own shares. Since Riggs Optical owned Riggs' shares, it exchanged these shares for its own shares. The court held[90] that the two steps must be viewed together and that since Riggs' stock in addition to Bausch Optical stock was transferred to Riggs from Bausch, the *solely* requirement was violated. Thus, the court held there was no valid reorganization. A similar case was *Grede Foundries v. United States*,[91] where plaintiff, the acquiring corporation, owned seventy per cent of the stock in the acquired corporation. There was an exchange of plaintiff corporation shares for all of the acquired corporation's assets (an attempted "C" reorganization). The acquired corporation was then liquidated. The shareholders of the acquired corporation, pursuant to the liquidation, surrendered their stock in exchange for the plaintiff's stock. Since plaintiff corporation already owned seventy per cent of the acquired corporation's shares, it received its own shares in the exchange. The Commissioner attacked the transaction on the grounds that plaintiff exchanged not only its own voting stock but also shares of the acquired corporation stock pursuant to the liquidation. The district court upheld the Commissioner.[92] The initial exchange of the stock for assets was a "C" reorganization, but the second step, the liquidation, was not. The court said "each step is part of one integrated plan, and for federal ineome tax purposes

88. Since the passage of the 1954 Code, there may be a section "B" reorganization when the acquisition of stock takes place in a series of transactions, if they take place over a relatively short period of time. Treas. Reg. § 1.368-2(c) (1955).
89. 267 F.2d 75 (2d Cir.), *cert. denied,* 361 U.S. 835 (1959).
90. 267 F.2d at 78.
91. 202 F. Supp. 263 (E.D. Wis. 1962).
92. *Ibid.*

the court must consider only the end result, not its component parts."[93]

Both cases illustrate that in planning a transaction it is necessary to take a look at the entire situation.[94] In many situations where there clearly appears to be a "B" or "C" reorganization, something may have transpired before the time of the exchange or something may happen in the future that will disqualify the plan. The cases also illustrate the dangers of unsophisticated tax planning. In either case exactly the same results could have been obtained by the use of an "A" reorganization and there would have been no danger of any gain being recognized. There was no attempt in these two cases to violate the policy of section 368, that is, there was no attempt to use section 368 as a device to put corporate earnings into the hands of shareholders without the payment of dividend taxes. Thus, the cases represent a triumph of mere technicalities without regard to policy considerations.

B. *Previous Cash Purchase of Stock*

The second type of transaction involves a previous cash purchase of stock of the acquired corporation by the acquiring corporation.

Lutkins v. United States,[95] involved the following situation: In 1912 Corporation *A*, the acquiring corporation, acquired sixty-five per cent of the stock of *B* Corporation in a stock exchange. Between 1929 and 1951, Corporation *A* made purchases on the market for cash of 2.69 per cent of *B* Corporation's outstanding stock. In 1952, there was an attempted "B" reorganization with *A* Corporation exchanging its shares for those of *B* Corporation. After the exchange, *A* owned ninety-four per cent of the stock of *B*. It was held that *A* did not acquire *B* stock solely for its own stock.[96] The previous cash purchases caused the disqualification.

It would appear there is a danger that any cash purchase of stock by one corporation of stock in another corporation might jeopardize a later "B" reorganization between the two corporations. However, there was a dissent in the *Lutkins* case on the grounds that the cash acquisition of the stock was unrelated to the plan of reorganization.[97] Also, the majority opinion relied on the Tax Court opinion in the *Mills* case,[98] which has subsequently been overruled.[99] Furthermore,

93. The Int. Rev. Code of 1939 § 112(g) added by, ch. 1, 53 Stat. 37, was involved, but it is identical in all material respect to § 368(a)(1)(C) of the 1954 Code.

94. The Court in both cases applied the "step transaction doctrine." See note 35 *supra*.

95. 312 F.2d 803 (Ct. Cl.), *cert. denied*, 375 U.S. 825 (1963).

96. Section 112(g) of the Int. Rev. Code of 1939, *supra* note 92 which is substantially the same as § 368(a)(1)(B) of the 1954 Code.

97. 312 F.2d 803, at 807.

98. See note 60 *supra*.

99. See note 58 *supra*.

the regulations provide that the purchase for cash of stock in the acquired corporation will not prevent a later "B" reorganization so long as the cash purchase is not part of the attempted reorganization.[100]

X. METHODS OF AVOIDING UNEXPECTED DISQUALIFICATION

A faulty brief in a tax case most often will not be fatal because it can probably be amended.[101] However, if the technical requirements of a section 368 reorganization are not met, there will probably be no way to correct the mistake. The fact that there were one or more alternative methods that would have resulted in tax free treatment and have accomplished the same result is irrelevant to the Commissioner.[102]

It is advisable to make the transaction as simple as possible. Many reorganizations, however, are by their very nature complex. Thus, hidden dangers and hence, disqualifications may result from reorganizations involving unusual and unique transactions.

Also, the practitioner should always use a checklist of the possible tax traps as a reminder in planning any merger or consolidation.

Finally, the contemplated reorganization can be protected by obtaining an advance ruling from the Commissioner of Internal Revenue.[103] If there is an ommission of a material fact in the statement given to the Commissioner, however, the advance ruling will afford no protection.[104] There will, of course, be situations where it will be impossible or impractical to obtain an advance ruling.[105] The absence of an advance ruling may determine the type of reorganization that will be used. For example, because of the strict *solely* requirement in a section "B" reorganization, it may be desirable to switch to a section "A" or a section "C" reorganization.

XI. CONSIDERATION OF POSSIBLE CHANGES IN THE LAW OF CORPORATE REORGANIZATIONS

In determining whether the law of reorganizations can be beneficially changed, it is necessary to review the purpose of section 368

100. Treas. Reg. § 1.368-2(c) (1954). This regulation had not been promulgated at the time of the exchange in the *Lutkins* case.

101. See FED. R. CIV. P. 15(a).

102. Grede Foundries, Inc. v. United States, *supra* note 91.

103. 26 C.F.R. § 601.201(a)(1) (Supp. 1963) (rulings).

104. *Ibid.*

105. Pursuant to 26 C.F.R. § 601.201(a)(1) (Supp. 1963) (rulings), an advance ruling will not be granted in certain areas. This writer believes that one area where an advance ruling may not be obtained is where there is a proposed corporate combination that would invclve a loss carryover.

and the relevant Code sections. The regulations state this purpose.[106] The general rule is that on the exchange of unlike property gain or loss must be recognized. This gain or loss is not to be recognized where there are only readjustments in corporate structures as required by the needs of business. In other words, no gain or loss is to be recognized unless there is a sale. Keeping the purpose in mind, it is difficult to understand why the boot limitations of "A", "B" and "C" reorganizations should be so different. The presumed purpose of the boot limitations is to insure that the acquired corporation shareholders have a continuing interest in the reorganized corporation.[107] Since a limited amount of boot may be exchanged in section "A" and "C" reorganizations, it is suggested that at least a small amount of boot be allowed in "B" reorganizations. It is difficult to see how such a change would defeat the purpose of the reorganization statutes.[108]

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106. See Treas. Reg. § 1.368-1(b) (1955).
107. See part III; note 34 *supra*.
108. *Reorganization Policies and Provisions: A Need for Clarification and Change*, 14 STAN. L. REV. 1848 (1962); Horrow, *supra* note 83, at 262.