Reorganization and the Closely Held Corporation

Charles P. Sacher

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr
Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.nd.edu/ndlr/vol49/iss4/2

This Article is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.
REORGANIZATION AND THE CLOSELY HELD CORPORATION

Charles P. Sacher*

I. Introduction

A great deal has been written concerning the subject of tax-free reorganizations. These articles are typically geared to covering the numerous technical requirements which must be met in order to secure the desired tax consequences. This author has been unable to find any article which concentrates on the problems of the stockholders of a closely held corporation. For the purposes of this article, a "closely-held corporation" is defined as one in which there has been no public distribution of stock, there are no more than ten (10) stockholders and one (1) stockholder owns, directly or indirectly, more than fifty (50%) percent of the corporation's outstanding stock. The purpose of this article is to discuss the requirements of a tax-free reorganization, particularly as they relate to the stockholders of a closely-held corporation. In accomplishing this purpose administrative and judicial interpretations of the statutory scheme will be discussed and their application to the closely held corporation will be considered. A discussion of the basic principles involved in corporate reorganizations precedes a more in-depth view of their utilization.

II. Reorganizations

"Reorganization" is generally defined in financial terms as: "a thorough reconstruction of a business corporation, comprising a considerable change in capital structure, as effected after, or in anticipation of, a failure and receivership." The legal definition of this term is similar:

The carrying out, by proper agreements and legal proceedings, of a business plan for winding up the affairs of or foreclosing a mortgage or mortgages upon the property of, insolvent corporations, more frequently railroad companies. It is usually accomplished by the judicial sale of the corporate property and franchises, and the formation by the purchasers of a new corporation. The property and franchises are thereupon vested in the new corporation and its stock and bonds are divided among such of the parties interested in the old company as are parties to the reorganization plan.2

However, when used in a tax3 context the term "reorganization" includes and encompasses certain specified types of corporate readjustments involving the exchange of stock or securities for property, stock or securities, generally so as to avoid or minimize the tax impact of the exchange. The application of the term

---

1 WEBSTER'S NEW WORLD DICTIONARY.
3 All references to taxes in this article will be limited to federal taxes.
"reorganization" in a tax context is specifically limited to the specific transactions described in Section 368(a) of the Internal Revenue Code of 1954.4

As will be discussed in greater detail later, the exchange of stock or securities generally results in the realization and recognition of taxable gain or loss. The stockholder of a closely-held corporation may wish to exchange his stock or cause his corporation to exchange its assets for the stock of a corporation which is publicly traded in order to eventually realize cash for his investment in his closely held corporation. Naturally, the stockholder could sell his stock or cause the corporation to sell its assets for cash. This sale would generate an immediate tax. The realization of a large gain may result in a larger tax liability than if the gain were realized over a period of years. Additionally, the immediate tax payment will result in substantially less investable cash, resulting in a reduced income. The tax liability arising from such immediate sale can generally be minimized through deferring the gain and spreading it over some future time. Similarly, the income can be maximized by spreading the gain over some future time, thus maximizing the pre-tax investment.

These deferral objectives can be accomplished through two methods: (1) electing the installment sale method of reporting gain;5 and (2) participating in a nontaxable exchange and then selling the newly-acquired property on a piecemeal basis. An installment sale permits the deferral of taxable income into future years as principal payments are received. The unpaid portion of the purchase price is generally evidenced by a non-marketable interest bearing obligation (on which interest income may be imputed)6 which permits the utilization of the pre-tax proceeds for investment purposes. The nontaxable exchange accomplishes the same results by deferring tax realization into future years when the property received in the exchange is ultimately disposed of in a taxable transaction. In the case of the nontaxable exchange of closely held stock for publicly held stock on which dividends are paid, the realization of current income at a reasonable rate is on the entire value of the property received in exchange and not merely on the net after tax proceeds.

This article will consider a specific type of nontaxable exchange—a corporate reorganization as described in Section 368 of the Internal Revenue Code of 1954.7

III. Corporate Reorganizations

There are three basic types of corporate reorganizations available to the stockholder of a closely-held corporation in order to accomplish a nontaxable exchange. These are the following:

1) Statutory merger or consolidation;
2) Exchanges involving solely voting stock; and

---
4 Treas. Reg. § 1.368-2(a).
6 Id. § 483.
7 Unless otherwise indicated, all textual references to sections of the Internal Revenue Code will refer to the Internal Revenue Code of 1954 and will be described as "Code."
3) Exchange involving assets solely for voting stock.

These three types of nontaxable corporate reorganizations are statutorily described in Section 368 of the Code as follows:

(a) Reorganization—

(1) In general.—For purposes of parts I and II of 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 has 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.  

As used herein, the statutory merger or consolidation described in Section 368(a)(1)(A) of the Code will be referred to as an "A" reorganization; the exchanges involving solely voting stock described in Section 368(a)(1)(B) of the Code will be referred to as a "B" reorganization; and an exchange involving assets solely for voting stock described in Section 368(a)(1)(C) of the Code will be referred to as a "C" reorganization.

Section 368 of the Code goes on to provide certain special rules as follows:

(2) Special rules relating to paragraph (1).—

(A) Reorganizations described in both paragraph (1)(C) and paragraph (1)(D).—If a transaction is described in both paragraph (1)(C) and paragraph (1)(D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1)(D).

(B) Additional consideration in certain paragraph (1)(C) cases.—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1)(C) but

---

8 INT. REV. CODE OF 1954, § 368(a)(1).
for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 per cent of the fair market value of all of the property of the other corporation,

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) Transfers of assets or stock to subsidiaries in certain paragraph (1) (A), (1) (B), and (1) (C) cases.—A transaction otherwise qualifying under paragraph (1) (A), (1) (B) or (1) (C) shall not be disqualified by reason of the fact that part or all of the assets or stock which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets or stock.

(D) Statutory merger using stock of controlling corporation.—The acquisition by one corporation, in exchange for stock of a corporation (referred to in this subparagraph as “controlling corporation”) which is in control of the acquiring corporation, of substantially all of the properties of another corporation which in the transaction is merged into the acquiring corporation shall not disqualify a transaction under paragraph (1) (A) if (i) such transaction would have qualified under paragraph (1) (A) if the merger had been into the controlling corporation, and (ii) no stock of the acquiring corporation is used in the transaction.

(E) Statutory merger using voting stock of corporation controlling merged corporation.—A transaction otherwise qualifying under paragraph (1) (A) shall not be disqualified by reason of the fact that stock of a corporation (referred to in this subparagraph as the “controlling corporation”) which before the merger was in control of the merged corporation is used in the transaction, if—

(i) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than stock of the controlling corporation distributed in the transaction); and

(ii) in the transaction, former shareholders of the surviving corporation exchanged, for an amount of stock in the surviving corporation which constitutes control of such corporation.*

9 Id. § 368(a) (2).
In order to qualify as a nontaxable exchange, the stock exchanged must be that of "a party to a reorganization." "A party to a reorganization" includes both a corporation resulting from a reorganization, and both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or property of another. If a "B" reorganization or "G" reorganization involves an exchange of stock of a corporation which is in control of the acquiring corporation, the corporation so controlling the acquiring corporation will be included within the definition of the term "a party to a reorganization." Finally, the controlling corporation in a transaction in which a wholly-owned subsidiary is used to effectuate a statutory merger will also be included within the definition of the term "a party to a reorganization."

For purposes of the reorganization provisions, the term "control" means the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.

Within the past few years Section 368 of the Code has been amended so as to make it more flexible. For example, all or part of the assets or stock acquired in an "A" reorganization, a "B" reorganization or a "C" reorganization may be immediately transferred to a corporation controlled by the acquiring corporation without affecting the nontaxable nature of the exchange. The utilization of the stock of a controlling corporation in a merger by the subsidiary corporation now qualifies as an "A" reorganization provided that it would have qualified as an "A" reorganization if the merger had been with the controlling corporation and no stock of the subsidiary is used in the transaction. This result was obtained in an administrative ruling promulgated prior to this amendment by disregarding "the transitory existence of the new subsidiary" and treating stock of the parent corporation which was first delivered to a wholly owned subsidiary which was to merge with the acquired corporation so as to eliminate dissenting minority stockholders as having been transferred directly to the stockholders of the acquired corporation. Similarly, the fact that in an otherwise qualified statutory merger stock of a corporation which before the merger was in control of the merged corporation is used in the transaction would not disqualify the transaction if (1) after the transaction, the corporation surviving the merger holds substantially all of its properties and of the properties of the merged corporation (other than

10 Id. § 368(b).
11 Id. § 368(c).
12 Id. § 368(a)(2)(C), effective for transfers made after February 26, 1964. The Service, in a ruling antedating the amendment of § 368(a)(2)(c) but relying on the statutory language of § 368(a)(1)(C) permitting the use of the stock of a parent corporation, ruled that a transaction in which a parent corporation and a corporation wholly owned by the parent's wholly-owned subsidiary acquired all the assets of an unrelated corporation qualified as a "G" reorganization. Rev. Rul. 64-73, 1964-1 Cum. Bull. 142. Presumably this same reasoning applies to "A" and "C" reorganizations after the amendment of § 368(a)(2) effective February 26, 1964.
14 Rev. Rul. 67-448, 1967-2 Cum. Bull. 144. Rev. Rul. 67-448 was distinguished in Rev. Rul. 73-427, 1973 Int. Rev. Bull. in which the Service ruled that no reorganization existed where 97% of stock was acquired for cash and the balance through the merger of a wholly owned corporation with the acquired corporation. Here also, "the transitory existence of the new subsidiary" was disregarded.
stock of the controlling corporation distributed in the transaction) and; (2) in
the transaction, former shareholders of the surviving corporation exchange, for
an amount of voting stock of the controlling corporation, an amount of stock in
the surviving corporation which constitutes control of such corporation.\footnote{15}

The term "reorganization" is to be strictly limited to the specific transactions
described in Section 368(a) of the Code. Reorganization does not encompass the
purchase by one corporation of the assets of another but rather implies a con-
tinuity of interest on the part of the transferor or its shareholders in the assets
transferred. "If the properties are transferred for cash and deferred payment
obligations of the transferee evidenced by short-term notes, the transaction is a
sale and not an exchange in which gain or loss is not recognized.\footnote{16}

The term "statutory merger or consolidation" (an "A" reorganization)
refers to a merger or consolidation effected pursuant to the corporation laws of
the United States or a State or territory of the District of Columbia.\footnote{17}

A "B" reorganization in which one corporation, in exchange solely for all
or a part of its voting stock (or that of its parent corporation) acquires stock of
another corporation is the most difficult nontaxable reorganization to ef-
flectuate. The difficulty of securing a nontaxable "B" reorganization arises from
the restrictive judicial and administrative interpretations of the term "solely
for all or a part of its voting stock." The ramifications of the restrictive definitions
will be discussed under the various separate headings of this article.
Before considering the specific illustrations of the effect of these restrictive
definitions, it is appropriate to consider the case of \textit{Helvering v. Southwest Con-
solidated Corp.},\footnote{18} which is the landmark decision interpreting the predecessor of
Section 368(a)(1)(B) of the Code. Section 112(g)(1)(B) of the Revenue Act
of 1934, provided in part, as follows:

\begin{quote}
The term "reorganization" means the acquisition by one corporation in
exchange solely for all or a part of its voting stock; of at least 80 per centum
of the voting stock and at least 80 per centum of the total number of shares
of all other classes of stock of another corporation; or of substantially all
the properties of another corporation.\footnote{19}
\end{quote}

The \textit{Southwest Consolidated Corp.} case involved a bankruptcy proceeding
in which a new corporation acquired the assets of a bankrupt corporation and
non-participating bondholders of the acquired corporation were paid off in
cash raised during the reorganization by a bank loan which was subsequently
assumed and repaid by the acquiring corporation. The issue before the Supreme
Court involved the cost basis of the acquired assets. If the exchange were a
nontaxable reorganization, the acquired corporation's cost basis would carry
over. However, if the exchange were a taxable exchange, the lower cost basis on
the acquisition price would apply. Pursuant to the plan of reorganization, the

\footnotesize{\begin{itemize}
\item[15] INT. REV. CODE of 1954, § 368(a)(2)(E), effective for statutory mergers occurring
after December 31, 1970.
\item[16] Supra note 4.
\item[17] Treas. Reg. § 1.368-2(b).
\item[18] 315 U.S. 194 (1942).
\end{itemize}}
majority of the common stock was issued to bondholders; a small portion, together with stock warrants, was issued to the unsecured creditors. Other stock warrants were issued to the preferred and common stockholders.

The Supreme Court held that the reorganization provisions did not apply to this transaction. In interpreting the "solely for all or a part of its voting stock" language of clause "B" of Section 112(g)(1) of the Internal Revenue Code of 1934, the Supreme Court stated:

Congress has provided that the assets of the transferor corporation must be acquired in exchange "solely" for "voting stock" of the transferee. "Solely" leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement. 20

There were two bases on which the Supreme Court held that this transaction did not qualify as a nontaxable "reorganization." First, the stock warrants did not constitute voting stock. Second, cash was paid to the non-participating bondholders. This cash payment was consideration and constituted something more than voting stock. The Supreme Court found that the acquiring corporation had paid, as part of the consideration for the transfer, cash in addition to its voting stock. The fact that it was paid to a bank rather than to the acquired corporation or its creditors was immaterial. The requirement to pay cash arose out of the reorganization itself. It derived, as did the requirements to pay stock, from the plan pursuant to which the properties were acquired. It was a necessary incident of the Court decree which wiped out the liability of the acquired corporation and substituted another one in its place.

Although the liability assumed had its origin in obligations of the acquired corporation, its nature and amount were determined and fixed in the reorganization. Accordingly, the Supreme Court held that neither the bank loan nor the cash payments to the non-participating bondholders could be labeled as an obligation of the acquired corporation. The assumption of such liabilities or taking property subject to a liability was permitted by a 1939 Amendment to Section 112(g)(1)(B) of the Internal Revenue Code of 1934. 21

This strict interpretation of the term "solely for all or a part of the voting stock" still controls the determination of whether an exchange constitutes a nontaxable reorganization as will be considered in the various sections of this article. The decision of whether or not the solely for voting stock requirement has been met must usually be resolved by determining if the other property involved in the transaction is given as "consideration" for the exchange.

In addition to the requirement that no consideration other than voting stock is given, a "B" reorganization also requires that the stock being exchanged is, in fact, voting stock. The equity interest being exchanged must give the recipient the present rights of a shareholder. This distinction was succinctly made by the

21 53 Stat. 862, 871 (1939), added language which retroactively amended Section 112(g)(1)(B) of the Internal Revenue Code of 1934, effective for 1934 to provide: [B]ut in determining whether the exchange is solely for voting 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.
Supreme Court in *Southwest Consolidated Corp.* In that case the Supreme Court held that the warrants which were issued were not "voting stock." Whatever rights a warrant holder may have to require the obligor corporation to maintain the integrity of the shares covered by the warrants, he is not a shareholder. A warrant holder does not have, and may never acquire, any legal or equitable rights in shares of stock. Such warrant holders cannot assert the rights of a shareholder. Accordingly, the acquisition in this case was not made "solely" for voting stock. Furthermore, it makes no difference that in the long run the unexercised warrants expired and nothing but voting stock was outstanding. Negotiable certificates of contingent interest in a like number of shares of voting stock do not constitute voting stock. These certificates were issued for a valid business reason because of uncertainty as to the value of the acquired corporation. The certificates entitled the holder to receive, at a specified future time, after reduction for any loss or expense, the number of shares of voting stock and dividends which were paid thereon in the interim. Although this transaction was part of an "A" reorganization and thus the reorganization qualified, the Internal Revenue Service ruled that the certificates were not stock but constituted "other property" and were taxable because the negotiable certificates had none of the attributes of corporate stock. Similarly, voting convertible preferred stock incorporating rights to purchase additional shares of stock at a future date does not qualify as solely voting stock and thus disqualified a "B" reorganization. Although the voting convertible preferred stock alone would qualify as voting stock, the inclusion of the "warrant" feature constituted something other than stock and disqualified the transaction.

In addition to coming within the statutory provisions quoted above, certain other conditions must be met. The purpose of the reorganization provisions of the Code is to exempt from taxation certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form and, except as provided in Section 368(a)(1)(D), a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization. In order to exclude transactions not intended to be included, the specifications of the reorganization provisions of the law are precise. Both the terms of the specifications and their underlying assumptions and purposes must be satisfied in order to entitle the taxpayer to the benefit of the exception from the general rule of taxation. Accordingly, under the Code a short-term purchase money note is not a security of a party to a reorganization, and an ordinary dividend is to be treated as an ordinary dividend, and a sale is never-

---

22 Supra note 18.
theless to be treated as a sale even though the mechanics of a reorganization have been set up.25

Section 368 of the Code requires that the transaction be made pursuant to a plan of reorganization. A plan of reorganization must contemplate the bona fide execution of one of the transactions specifically described as a reorganization in Section 368(a) of the Code and for the bona fide consummation of each of the requisite acts under which non-recognition of gain is claimed. Such transaction and such acts must be ordinary and necessary incidents of the conduct of the enterprise and must provide for a continuation of the enterprise. Under prevailing treasury regulations:

[Any scheme] which involves an abrupt departure from normal reorganization procedure in connection with a transaction on which the imposition of a tax is imminent, such as a mere device that puts on the form of a corporate reorganization as a disguise for concealing its real character, and the object and accomplishment of which is the consummation of a preconceived plan having no business or corporate purpose is not a reorganization.26

Just as the "B" reorganizations involve the question of solely for voting stock, a "C" reorganization involves the same question (with an exception which may be of limited applicability dealing with situations in which properties amounting to eighty (80%) percent of the fair market value of all properties are acquired solely for voting stock) as well as the question of what constitutes an exchange of "substantially all of the properties" of another corporation. The solely for voting stock requirement brings into play the same limitations as apply in a "B" reorganization. There is a specific statutory provision that the assumption of a liability or the taking of property subject to a liability shall be disregarded and does not constitute consideration other than voting stock.27 A transaction will still qualify as a "C" reorganization even if money or other property is exchanged by the acquiring corporation in addition to its voting stock if the acquiring corporation acquired "solely for its voting stock" property of the other corporation having a fair market value which is at least 80% of the fair market value of all of the property of the other corporation. However, if money or other property is utilized, then the amount of any liability assumed by the acquiring corporation and the amount of any liability to which other property acquired by the acquiring corporation is subject shall be treated as money paid for the property.28 Thus, the utilization of any consideration other than voting stock will require an analysis of the total amount of the liabilities of the acquired corporation and, in most business situations, will defeat the nontaxable nature of the exchange.

25 Treas. Reg. § 1.368-1(b). For the purposes of this article, it will be assumed that the reorganizations described are for a valid business purpose and involve a sufficient continuity of interest. 26 Treas. Reg. § 1.368-1(c). 27 The same exception was considered by the Supreme Court in Helvering v. Southwest Consolidated Corp., supra note 18. Some problems have arisen because this exception is not included in § 368(a)(1)(B). However, the effect of acquiring stock is to assume the liabilities of the acquired corporation. 28 INT. REV. CODE OF 1954, § 368(a)(2)(B).
The second consideration in connection with a "C" reorganization is whether or not there has been a transfer of "substantially all" the assets of the acquired corporation. Since the closely held corporation will generally be the acquired or "target" corporation, it is essential for the stockholder of the closely held corporation to insure that the "substantially all" test is met. The question of whether or not this "substantially all" test is met is generally a question of fact dependent upon the facts and circumstances of each transaction. If the transaction involves the transfer of all of the operating assets of the acquired corporation, retention of cash and accounts receivable may be disregarded. For example, the transfer of 86% of the total net worth, including all of the assets essential to the operation of the business, has been held to qualify as a "C" reorganization. The retention of surplus cash amounting to 18% of the acquired corporation's net worth which could have been distributed as an ordinary dividend did not make an otherwise qualified "C" reorganization taxable. The retention by an acquired corporation of cash to pay its liabilities or bondholders does not defeat the requirements that substantially all of the properties be transferred. The gravamen of all decisions approving the retention of assets by the corporation whose assets were being acquired was that all operating assets must be exchanged and only non-operating assets, particularly cash, were retained.

IV. General Tax Consequences of Reorganizations

The Code provides generally that no gain or loss will be recognized by participants in a reorganization if stock or securities of a corporation which is a party to a reorganization are "in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." Gain or loss will be recognized if either the principal amount of any securities received exceeds the principal amount of any securities surrendered, or any such securities are received and no such securities are surrendered.

A special rule applies to a divisive reorganization. Additionally, special

---

29 Comm'r. v. First Nat'l Bank, 104 F.2d 865 (3rd Cir. 1939).
30 Gross v. Comm'r., 88 F.2d 567 (5th Cir. 1937).

31 Roosevelt Hotel Co., 13 T.C. 399 (1949); Westfir Lumber Co., 7 T.C. 1014 (1946); Southland Ice Co., 5 T.C. 842 (1945); Rev. Rul. 57-518, 1957-2 CUM. BULL. 253 in which the Service ruled that the transfer of seventy (70%) percent of the total assets met the "substantially all" requirement of a "C" reorganization because the retained assets were approximately equal to the liabilities and were confined to cash, accounts receivable, notes and three percent of the total inventory.

32 INT. REV. CODE OF 1954, § 354(a) (1).
33 Id. § 354(a) (2).
34 Id. § 354(b).
35 Id. § 368(a) (1) (D) defines a divisive reorganization as:

[A] transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356 . . . .

As used herein a divisive reorganization described in § 368(a) (1) (D) will be referred to as a "D" reorganization.
rules apply in connection with the distribution of stock attendant upon a divisive reorganization.\textsuperscript{36} The divisive reorganization is outside the scope of this article and will only be discussed in the context of the disposition of unwanted assets and the elimination of dissenting minority stockholders by the closely held corporation.

The general rule of non-recognition of gain or loss applies only if stock and securities (or only stock in certain reorganizations) are exchanged. If other property is utilized and if the transaction otherwise qualifies as a reorganization, then any gain will be recognized but in an amount not in excess of the sum of any money and the fair market value of the other property\textsuperscript{37} including the cancellation of shareholder indebtedness.\textsuperscript{38} An "A" reorganization will qualify regardless of the amount of other property involved provided that the business purpose and continuity of interest requirements are satisfied. A "B" reorganization will not exist if any consideration other than voting stock is given by the acquiring corporation. A "C" reorganization generally requires that only voting stock be given as consideration; but a transaction will qualify as a "C" reorganization if at least eighty (80\%) percent of the fair market value of all assets is acquired solely for voting stock. Since operating businesses generally have liabilities in excess of twenty (20\%) percent of such value encumbering the assets, this exception is of limited utility. If the transaction does not otherwise qualify as a reorganization, the entire consideration received (stock, securities and other property) will constitute the measure of the gain.\textsuperscript{39} The receipt of money and other property is referred to as "boot." Receipt of boot in an otherwise nontaxable exchange will not give rise to the recognition of a loss.\textsuperscript{40} Different and more complex rules apply in connection with distributions incident to divisive reorganizations coming within the ambit of Section 355 of the Code.\textsuperscript{41}

If the receipt of boot gives rise to recognition of gain, such gain may be taxable as a dividend, as gain from the exchange of property, or as a combination thereof. If the exchange has the effect of the distribution of a dividend, then there shall be treated as a dividend to each distributee such an amount of the recognized gain as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the recognized gain shall be treated as gain from the exchange of property.\textsuperscript{42}

Whether or not the exchange has the effect of the distribution of a dividend may be resolved under the principles enunciated under Section 302(b)(1) of the Code. Any money or other property which is distributed pro rata to those persons who were stockholders of the acquired corporation at the time of the reorganization pursuant to the plan of reorganization will be treated as a dividend to the extent of the ratable share of the accumulated earnings and profits.\textsuperscript{43}

\textsuperscript{37} \textit{Id.}, § 356(a)(1).
\textsuperscript{38} Hawkinson v. Comm'r., 235 F.2d 747 (2nd Cir. 1956).
\textsuperscript{40} \textit{Int. Rev. Code of 1954}, § 356(c).
\textsuperscript{41} \textit{Id.}, § 356(b), (d).
\textsuperscript{42} \textit{Id.}, § 356(a)(2); Rev. Rul. 57-586, supra note 23.
The corporate dividend received deduction\textsuperscript{44} will be available to a corporation in such a circumstance.\textsuperscript{45} However, through the application of Section 302 (b)(1) of the Code, it has been held that the distribution of boot in the form of a promissory note in an “A” reorganization did not constitute a dividend when the distributees’ stock interest in the consolidated corporation was 23\% less than their stock ownership before consolidation.\textsuperscript{46} The receipt of money or other property by a person in a capacity other than a stockholder, such as a creditor, may still result in a recognized gain. Such gain will not be treated as a dividend.\textsuperscript{47}

The preceding discussion regarding the characterizations of boot does not apply to money received under certain circumstances. Cash received in lieu of the issuance of fractional shares\textsuperscript{48} will be taxed as gain from the exchange of property\textsuperscript{49} unless such cash did not represent a mere mechanical rounding off of the fractional shares but was a separately bargained for consideration.\textsuperscript{50} Such a result can only obtain in an “A” reorganization because such separately bargained for consideration would destroy a nontaxable “B” reorganization and may destroy a “C” reorganization. Cash received in exchange for property\textsuperscript{51} will also be taxed as gain from the exchange of property. Property distributions prior to the exchange\textsuperscript{52} may be taxed as a dividend, as gain from the exchange of property, or a combination thereof. Cash received in payment of a liability is nontaxable.\textsuperscript{53}

In determining the amount of boot received in an otherwise nontaxable exchange it is sometimes necessary to consider the liabilities of the acquired corporation. The assumption of a liability or the acquisition of property subject to a liability will always be taken into account in determining the amount of gain realized. Under certain circumstances and in certain exchanges such assumption or acquisition will not result in the recognition of gain. The general rule of non-recognition of gain provides that if the exchanging taxpayer receives property which would be permitted to be received in an exchange without the recognition of gain if it were the sole consideration and as part of the consideration another party to the exchange assumes such taxpayer’s liability, or acquires from such taxpayer property subject to a liability, then such assumption or acquisition shall not be treated as money or other property and will not prevent the exchange from being consummated without the recognition of gain.\textsuperscript{54} This general rule is only applicable to otherwise tax-free incorporations,\textsuperscript{55} nontaxable

\textsuperscript{44} \textit{Int. Rev. Code} of 1954, § 243(a).
\textsuperscript{45} Rev. Rul. 72-327, 1972-2 \textit{CUM. BULL.} 197.
\textsuperscript{48} \textit{Infra} note 81.
\textsuperscript{49} Rev. Rul. 66-365, 1966-2 \textit{CUM. BULL.} 116 applicable to both “B” reorganizations and “C” reorganizations; Rev. Rul. 69-34, 1969-1 \textit{CUM. BULL.} 103 applicable to a reorganization described in § 368(a)(1)(B).
\textsuperscript{50} Tenney Ross \textit{v. United States}, 173 F. Supp. 793 (Ct. Cl. 1959); Rev. Rul. 56-220, 1956-1 \textit{CUM. BULL.} 191.
\textsuperscript{51} See text accompanying note 86 \textit{infra}.
\textsuperscript{52} See text accompanying notes 82-85 \textit{infra}.
\textsuperscript{53} See text accompanying note 95 \textit{infra}.
\textsuperscript{54} \textit{Int. Rev. Code} of 1954, § 357(a).
\textsuperscript{55} \textit{Id.} § 351.
reorganizations in which liabilities are directly involved,\textsuperscript{56} reorganizations in certain insolvency receivership and bankruptcy proceedings,\textsuperscript{57} and certain insolvency railroad reorganizations.\textsuperscript{58} The assumption of a liability or acquisition of property subject to a liability will otherwise be taken into account for the purpose of computing the amount of gain or loss realized under Section 1001 of the Code upon an exchange.\textsuperscript{59}

There are two exceptions to this general rule. First, an assumption or acquisition will be considered money received by the taxpayer on the exchange if, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption or acquisition was made, it appears that the principal purpose of the taxpayer with respect to the assumption or acquisition:

(1) was a purpose to avoid Federal Income Tax on the exchange or,
(2) if not such purpose, was not a bona fide business purpose.\textsuperscript{60}

In any suit or proceeding the burden is on the taxpayer and the burden shall not be considered as sustained unless the taxpayer supports his position by a clear preponderance of the evidence.\textsuperscript{61} If either of the foregoing purposes is present, the total amount of liabilities assumed or acquired pursuant to such exchange (and not merely a particular liability with respect to which the tax avoidance purpose existed) shall be treated as money received for the purpose of determining the amount of gain to be recognized upon such exchange.\textsuperscript{62} The second exception provides that, for purposes of a tax-free incorporation or a divisive reorganization,\textsuperscript{63} if the sum of the amount of liabilities assumed plus the amount of the liabilities to which the property is subject exceeds the total of the adjusted basis of the property transferred pursuant to such exchange, then such excess shall be considered as a gain from the sale or exchange of a capital asset or of property which is not a capital asset as the case may be.\textsuperscript{64} This second exception does not apply if a tax-avoidance purpose or a nonbusiness purpose is present or to the insolvency reorganizations described above.\textsuperscript{65}

As with individuals, no gain or loss shall be recognized to a corporation if the corporation, as a party to a reorganization, exchanges property in pursuance of a plan of reorganization solely for stock or securities in another corporation.\textsuperscript{66} If a corporation receives property which would be permitted to be received in an exchange without the recognition of gain if it were the sole consideration as well as other property or money, then:

\begin{itemize}
  \item \textsuperscript{56} Id. §§ 361, 368(a)(1)(A), 368(a)(1)(C), and 368(a)(1)(D).
  \item \textsuperscript{57} Id. § 371.
  \item \textsuperscript{58} Id. § 374.
  \item \textsuperscript{59} Treas. Reg. § 1.357-1(a).
  \item \textsuperscript{60} INT. REV. CODE of 1954, § 357(b)(1).
  \item \textsuperscript{61} Id. § 357(b)(2).
  \item \textsuperscript{62} Treas. Reg. § 1.357-1(c).
  \item \textsuperscript{63} Supra note 35.
  \item \textsuperscript{64} INT. REV. CODE of 1954, § 357(c).
  \item \textsuperscript{65} Id. § 357(c)(2).
  \item \textsuperscript{66} Id. § 361(a).
\end{itemize}
(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 so received, which is not so distributed. 67

As in the case of the receipt of boot by an exchanging taxpayer, 68 the receipt of other property or money by a corporation in exchange in which gain or loss is not otherwise recognized, then no loss from the exchange shall be recognized. 69

The cost basis of the stock received by the exchanging stockholder of the closely held corporation in a totally nontaxable exchange will equal the cost basis of the stock in the closely held corporation. 70 This cost basis will be increased by the amount of any dividend and the amount of any recognized gain, but not including any portion of such gain which was treated as a dividend. 71 The cost basis will be decreased by the fair market value of any other property received, the amount of any money received and the amount of any recognized loss. 72 The foregoing rules do not apply to the acquiring corporation in an “A” reorganization or a “C” reorganization. 73 In such reorganizations, the transferor’s basis will carry over, increased by any recognized gain. 74

The objective of the stockholder of a closely held corporation participating in a reorganization 75 should be to insure that it will be nontaxable, or if taxable, that the recognized gain is limited to the money and property other than stock or securities received. There are numerous situations which may confront such stockholder in a typical reorganization. This article will attempt to canvass the possible problems which may be encountered, the considerations attendant upon the type of reorganization involved, and the judicial and administrative interpretations thereof.

V. Structuring the Form of the Reorganization

The stockholder of a closely held corporation initially may structure the nontaxable exchange as either an “A”, a “B”, or a “C” reorganization. The acquiring corporation will generally dictate the form of the transaction. However, the success or lack thereof in having the transaction structured along the most beneficial lines for the stockholder of the closely held corporation is generally determined by the initial demands made on behalf of such stockholder and the

67 Id. § 361(b)(1).
68 Supra note 37.
69 INT. REV. CODE of 1954, § 361(b)(2).
70 Id. § 358(a)(1).
71 Id. § 358(a)(1)(B).
72 Id. § 358(a)(1)(A).
73 Id. § 358(c).
74 Id. § 362(b).
75 For the purposes of this article it will be assumed that the proposed exchange will result in an economic gain to the stockholders.
importance of this acquisition to the acquiring corporation. As will be demonstrated, an "A" reorganization is generally the most attractive to the stockholder of the acquired corporation because it presents the least danger of having the exchange determined to be fully taxable. The "C" reorganization affords the next most attractive vehicle because of the limited exception for the receipt of consideration other than voting stock. The "B" reorganization is the most restrictive because the receipt of any consideration other than voting stock will render the entire transaction fully taxable. At first glance it appears that a public corporation will not participate in an arrangement whereby it will have a closely held corporation merged into it so the "A" reorganization seems of doubtful utility. Nevertheless, an "A" reorganization can be effectuated through the medium of a subsidiary formed and utilized solely for that purpose. A similar result can be reached for a "C" reorganization.

It has been the author's experience that the representatives of the acquiring corporation do not desire to place stumbling blocks in the way of structuring the transaction in the best tax interests of the stockholder of the acquired corporation; neither are they inclined to render any tax advice nor to rearrange a transaction after the initial agreements regarding the type of transaction have been reached. Thus, it is essential that the best vehicle for the stockholder of the acquired corporation be advanced at the earliest opportunity in order to maximize the possibility that the transaction will be structured to his tax advantage.

The remainder of this article will be devoted to a discussion of some of the various problems which may arise in representing the stockholder of a closely held corporation entering into a corporation reorganization. Two problem areas will be considered. They are: 1) the effect on a reorganization of the receipt of property other than voting stock and 2) the application of the "step-transaction" doctrine to this type of reorganization.

VI. Receipt of Property Other Than Voting Stock

A. Introduction

Whether or not the stockholder of a closely held corporation can receive cash or other property in connection with an exchange and still qualify as a nontaxable reorganization depends upon both the section under which the transaction is intended to qualify and the purpose of the payment. Generally speaking, transactions intended to qualify as statutory mergers or consolidations, "A" reorganizations, afford the greatest opportunity of permitting the receipt of cash. Thus, cash, non-voting stock, securities, and other properties may be received in connection with an "A" reorganization without violating the statutory language. The receipt of such items will, of course, give rise to "boot" with the attendant tax consequences mentioned earlier. However, the utilization of such other consideration should not be done with impunity. The "continuity of

76 The Service has ruled that such a transaction qualifies as a "B" reorganization because the assets of the acquired corporation were neither transferred to nor acquired by any other corporation. Rev. Rul. 67-448, supra note 14.
interest" requirement of reorganizations in general must be recognized and observed. Thus, the transaction will not qualify as an "A" reorganization if only bonds of the surviving corporation are exchanged because the stockholders of the acquired corporation did not retain a continuing proprietary interest in the transferred assets.\(^7\) Similarly, the "continuity of interest" requirement will not be met where the stockholders of the acquired corporation receive stock which represents only a minute part of the total consideration in the transaction.\(^8\)

As explained above, the utilization of any consideration other than voting stock will preclude the nontaxable status of a "B" reorganization. The important point to note here is that the cash or other property received cannot constitute consideration for the exchange of stock. As will be subsequently illustrated there are some situations in which cash may be received by the stockholder of the acquired corporation in a "B" reorganization without losing the nontaxable nature of the "B" reorganization.

As previously stated, cash or other property may, under limited circumstances, be received as consideration in connection with a "C" reorganization. However, in order for this rule to apply the acquiring corporation must acquire eighty (80%) percent of the fair market value of the assets of the acquired corporation solely in exchange for voting stock and the liabilities of the acquired corporation may be taken into account in determining the amount of consideration involved. It would be an unusual situation in which the liabilities of the acquired corporation do not exceed 20% of the fair market value of the assets of that corporation. Accordingly, if the more than 20% rule applies then no cash or other property could be exchanged in consideration for the properties in a transaction which is intended to qualify as a "C" reorganization.

**B. Cash Payments**

Cash may be received in an "A" reorganization without making the entire transaction taxable provided that the business purpose and continuity of interest tests are met.\(^9\) The stockholder in a "B" reorganization or "C" reorganization may receive cash without regard to the limitations recited above if the cash represents merely a mechanical rounding of the purchase value of the stock so as to avoid the receipt of fractional shares. At one time even this receipt of cash would have disqualified a "B" reorganization. However, the courts\(^8\) and the Service\(^9\) have both recognized that the receipt of cash in connection with the mere rounding off of fractional stock interests will not defeat an otherwise quali-

---

77 Roebling v. Comm'r., 143 F.2d 810 (3d Cir. 1944).
78 Southwest Natural Gas Co. v. Comm'r., 189 F.2d 332 (5th Cir. 1951).
79 Rev. Rul. 72-327, supra note 43, described the tax consequences to an exchanging stockholder who received stock and other property in an "A" reorganization. Gain was recognized in an amount not to exceed the fair market value of the other property. The recognized gain was treated as a dividend to the extent of the stockholders' ratable share of the acquired corporation's earnings and profits accumulated after February 28, 1913, and the excess was treated as gain from the exchange of property.
80 Mills v. Comm'r., 331 F.2d 321 (5th Cir., 1964).
fied nontaxable exchange. The important requirement here is that there be no separately bargained for receipt of cash. It must not be an independent part of the consideration but must represent a mere rounding off of the fractional shares which would otherwise be issued in connection with the exchange formula.

The stockholder in a "B" reorganization or "C" reorganization may also receive cash through the payment of a dividend by the acquired corporation. The receipt of cash cannot be found to be consideration for the exchange or in exchange for the stock. Also, the dividend must apparently be paid out of the acquired corporation’s own funds. Subject to the foregoing, the dividend may be paid pursuant to the plan of reorganization in an amount equal to the net earnings of the acquired corporation for a specified period prior to the acquisition or in an amount equal to the dividends which would have been paid by the acquiring corporation had the exchange taken place on the originally scheduled date. The payment after the acquisition of a regular year-end dividend declared before the exchange has also been approved.

The stockholder may also receive cash or other property on account of transactions antedating the exchange. Thus, the distribution of property to the stockholder by an acquired corporation immediately prior to an exchange did not disqualify a "B" reorganization because the distribution did not constitute consideration for the exchange. The receipt of cash in exchange for stock, either prior to the exchange as a sale or after the exchange as a redemption, is subject to close scrutiny. Thus, where the prior sale was found to be part of an integrated plan the cash payment disqualified a "C" reorganization. Conversely, where the cash redemption was found to be independent and not part of an integrated plan, the transaction qualified as a "C" reorganization. Cash received from a sale of fifty (50%) percent of the stock of the acquired corporation to the president of the acquiring corporation, acting solely in his individual capacity, did not disqualify a "B" reorganization. The president owned the stock individually and there was no arrangement to reimburse the president for his cash expenditure. Moreover, there was no indication that such a sale was not part of the overall transaction.

Great caution must be observed in any transactions involving sales of stock for cash either before or after the exchange. The Service can also seek to apply the "step transaction" doctrine to disqualify a reorganization. As evidence of the caution required, a public corporation made an unrestricted sale of stock of a corporation it intended to acquire in a "B" reorganization to an unrelated

83 Rev. Rul. 56-184, supra note 82.
84 Rev. Rul. 68-435, supra note 82.
85 Rev. Rul. 69-443, supra note 82.
86 Rev. Rul. 70-172, 1970-1 CUM. BULL. 77.
88 Rev. Rul. 56-345, 1956-2 CUM. BULL. 206.
90 Rev. Rul. 56-345, supra note 88.
92 Rev. Rul. 56-345, supra note 88.
third party prior to making the exchange offer so as to preclude the possibility that the subsequent exchange would not qualify as a "B" reorganization. 33

The receipt of cash and other property may affect the nontaxable nature of an exchange in various ways. Thus, the stockholder may redeem preferred stock as part of the reorganization. A "B" reorganization was approved where a stockholder who owned all the outstanding non-voting preferred stock and substantially all of the outstanding common stock entered into an agreement under which the acquired corporation redeemed his preferred stock at par. Immediately thereafter, all of the outstanding common stock was exchanged in a transaction otherwise qualifying as a "B" reorganization. The Tax Court held that the redemption of the stockholder's preferred stock was not essentially equivalent to a dividend. 34 The facts in this case are particularly interesting because the taxpayer had agreed to exchange both his preferred and common stock for the common stock of the acquiring corporation. This agreement was never consummated, and in its place the parties agreed to a plan of reorganization whereby the taxpayer would redeem his preferred stock at par and then would exchange his common stock for the common stock of the acquiring corporation. The difference between the stock involved in these two transactions was based upon the cash which would be used in redemption of the preferred stock. The taxpayer advised the acquiring corporation that his corporation did not have sufficient cash to effect the redemption. Accordingly, the acquiring corporation recommended that the acquired corporation obtain a short-term bank loan which was used in part to effect the redemption of the preferred stock and to satisfy bonus and backpay obligations. At the time the loan was made the bank had a copy of the plan of reorganization which indicated that the reorganization was to take place in the near future. Redemption took place seven days before the stock exchange. At the closing the acquiring corporation made a capital contribution to the acquired corporation, a part of which was used to pay off the bank loan. The taxpayer did not originate the plan to effectuate the redemption and both the plan of redemption and the bank loan were suggested by the acquiring corporation. In this case the Tax Court acknowledged that the Service had considered the redemption of the preferred stock and the exchange of the common stock to be separate transactions and conceded that the exchange constituted a nontaxable "B" reorganization.

Cash payments in retirement of preferred stock which was duly called in accordance with its terms did not disqualify a "B" reorganization because upon notification the preferred stockholders became creditors of the acquired corporation. 35 A similar result should obtain in connection with the sale of any other asset to either the acquired or the acquiring corporation and the receipt of cash from such sale should not disqualify a "B" reorganization or a "C" reorganization. This result was specifically approved for convertible debentures which were sold to the acquiring corporation. 36 However, the Service in approving this "B" re-

organization specifically commented on the fact that the owner of the debentures owned no stock in the acquired corporation. This ruling was decided on the basis that the convertible debentures did not constitute stock and it would seem that this ruling would apply equally if the debenture owner was also a stockholder. Cash paid by an acquired corporation to its employees (some of whom apparently were stockholders) as consideration for the termination of a qualified employee stock option plan as required by the plan of reorganization did not disqualify a "B" reorganization.97

The receipt of cash or other property by any stockholder of an acquired corporation as consideration for the exchange of stock will disqualify a "B" reorganization. Thus, the controlling stockholder must be concerned with transactions involving any minority stockholders. This area becomes particularly important where there are dissenting stockholders involved. It is clear that if the acquired corporation's own assets are retained to pay its liabilities, including its bondholders, that this will not defeat a "C" reorganization.98 The effect of paying dissenting stockholders is not so patent.

The case of Hoboken Land & Improvement Co. v. Commissioner99 contains a good example of the judicial interpretation of the phrase "solely for voting stock" as it applies to cash payments to dissenting stockholders. The stockholders of an acquired corporation furnished funds to pay off dissenting stockholders. It was held in this case that although certain cash was made available by the acquiring corporation, its use was restricted to being reinvested in the acquiring corporation. The cash paid to dissenting stockholders came from one of the stockholders of the acquired corporation, who then received the stock of the acquiring corporation which would have gone to the dissenting stockholders had they participated. In distinguishing the case of Helvering v. Southwest Consolidated Corp.100 the Court noted that in Southwest Consolidated Corp. the money was furnished by a third party as part of a loan transaction in which the acquiring corporation was the debtor so that it was as if the acquiring corporation had made the payment itself. In the Hoboken case the acquiring corporation did not advance the funds that were used to pay off the dissenting stockholders.

A qualified "B" reorganization was found to exist where a wholly owned subsidiary was funded solely with voting stock and utilized as a vehicle to merge with the acquired corporation to take advantage of the statutory merger provisions which permitted dissenting stockholders to be paid in cash.101 Disregarding the transitory nature of the subsidiary, the Service held that the acquisition of ninety-five (95%) percent of the stock of the acquired corporation, with the dissenting stockholders being paid in cash out of the acquired corporation's funds, qualified as a "B" reorganization. The Service based its decision on the fact that the acquiring corporation used solely its voting stock. A "B"

98 Westfir Lumber Co., 7 T.C. 1014 (1946); see also Southland Ice Co., 5 T.C. 842 (1945), in which assenting creditors were paid in cash out of retained funds available as a result of operations during receivership.
99 134 F.2d 104 (3d Cir. 1943).
100 Supra note 18.
Reorganization was held to exist where seventy-five (75%) percent of the acquired corporation was acquired for stock and the remaining stockholders who dissented from the exchange were paid off in cash from an escrow account funded by the acquired corporation.\textsuperscript{102} The Service relied on the fact that, under the applicable stock law, the dissenting stockholders immediately ceased to be stockholders upon the exchange and their rights were limited to receiving the fair market value of their stocks. Additionally, the Service specifically held that the funds must be those of the acquired corporation and included the following limitation:

\begin{quote}
However, it should be noted that Section 368(a)(1)(B) of the Code does not treat as a reorganization any transaction in which the acquiring corporation pays the dissenting shareholders or reimburses the acquired corporation for its payment to the dissenting shareholders.\textsuperscript{103}
\end{quote}

The exception to the solely for voting stock requirement of a “C” reorganization was applied in the case of cash payments by the acquiring corporation to dissenting stockholders of the acquired corporation.\textsuperscript{104} The Service noted that the liabilities of the acquired corporation plus the cash paid to dissenting stockholders amounted to ten (10%) percent of the fair market value of all assets. The Service relied on Southwest Consolidated Corp. in holding that the payment of the liabilities to dissenting stockholders was not the payment of an assumed liability but constituted additional consideration for the stock exchange. Because the percentile limitations of Section 368(a)(2)(B) of the Code were met, this transaction qualified as a “C” reorganization effective after the taxable year considered by the Supreme Court in Southwest Consolidated Corp.

The transactions involving payment to dissenting stockholders illustrate three possibilities. It is obvious that any payment by the acquiring corporation will constitute additional consideration which will violate the solely for voting stock requirement. In order to satisfy the solely for voting stock requirement the acquired corporation must supply the funds necessary to make the payments. Furthermore, it appears necessary that the applicable state law must terminate the dissenters’ rights as stockholders immediately upon the exchange. Assuming that these conditions can be met, the controlling stockholder of a closely held corporation should be able to effectively remove any dissenting stockholders in consummating a nontaxable reorganization.

\section*{C. Liabilities: Assumed, Paid, Substituted}

The nontaxable nature of an otherwise qualified reorganization may be affected by the assumption, payment, or satisfaction of such liabilities or by the substitution of the acquiring corporation’s liabilities for those of the acquired corporation. The liabilities may be those of the stockholder or third parties.

The legal consequences of both an “A” reorganization and a “B” reorga-

\begin{footnotesize}
\begin{enumerate}
\item Id.
\end{enumerate}
\end{footnotesize}
nization result in the acquiring corporation assuming the liabilities of the acquired corporation. Thus, such assumption should not affect the nontaxable nature of an "A" reorganization, and except for liabilities arising as consideration for the reorganization, such assumption should not affect the nontaxable nature of a "B" or a "C" reorganization. As discussed above, special rules apply in connection with the assumption of liabilities in a "C" reorganization. To summarize: such assumption does not constitute other consideration unless property in addition to voting stock is exchanged; if other property is exchanged both the assumption of liabilities and taking property subject to a liability constitute money or other property. Even in an asset acquisition, the amount of liabilities involved may be such as to disqualify the transaction as a nontaxable exchange because the character of the transaction may be so altered as to place it outside the purposes and assumptions of the reorganization provisions.

The entire question of the payment, satisfaction, or assumption of liability was fully discussed in the case of Stockton Harbour Industrial Co. v. Commissioner. The acquiring corporation obtained all of the assets of another corporation in exchange for its voting stock and cash. The cash was in the exact amount of unpaid interest and past-due property taxes and was to be used to pay the existing interest and tax liability. The issue was whether or not this transaction was a "reorganization" within the definition of the predecessor of Section 368 (a)(1)(C) of the Code. The court then considered the cases of United States v. Hendler and Southwest Consolidated Corp. The Supreme Court in the Hendler decision held that the assumption by the acquiring corporation in a transaction, which would otherwise qualify as a "C" reorganization, of the liabilities of the acquired corporation was in substance the same as the payment of cash to the acquired corporation. The Court stated:

The Hendler Company was the beneficiary of the discharge of its indebtedness. Its gain was as real and substantial as if the money had been paid it and then paid over by it to its creditors. The discharge of liability by the payment of the Hendler Company's indebtedness constituted income to the Hendler Company and is to be treated as such.

The Supreme Court in Southwest Consolidated Corp. stated that the amendment of the operative reorganization provision which provided that the assumption by the acquiring corporation of liability of the acquired corporation or the fact that property acquired is subject to a liability shall be disregarded was made to avoid the consequences of Hendler. The Court then went on to analyze in detail the differing considerations in connection with the tax consequences of the assumption or payment of liability in a "C" reorganization. The Court further stated:

When this is done, it will be seen that only when a debt, although originating

105 Supra note 18.
107 216 F.2d 638 (9th Cir. 1954).
108 303 U.S. 564 (1938).
109 Id. at 566.
in the obligation of the transferor, is of such character that its nature and amount are determined and fixed in the reorganization, will the Courts disregard its liquidation by cash as a part of the reorganization. And conversely, when the nature and amount of a debt arising from a pre-existing obligation are determined and fixed prior to the reorganization, the payment of cash to liquidate it is treated as a payment on a liability assumed. 110

The Court then went on to analyze various holdings, the sum and substance of which were that cash payments would be considered to be additional consideration and defeat the nontaxable reorganization provisions where the cash was used to pay an obligation, although having its origin in obligations of the acquired corporation, whose nature and amount were determined and fixed in the reorganization; and accordingly, the acquiring corporation in agreeing to pay such cash did not assume an obligation of the acquired corporation or acquire the assets subject to a liability of the acquired corporation. In analyzing the reason for the payment of cash in the instant case the Court stated:

The amounts arrived at were the result of mathematical calculations based upon the amount of each indebtedness, the rate of interest and the period during which it remained unpaid. So the indebtedness as to interest was the liquidation of a debt the nature and extent of which was fixed prior to the reorganization. It did not arise in the reorganization. It was a pre-existing obligation which did not require the reorganization to acquire certainty. The same is also true of the taxes. The obligation to pay taxes existed by reason of the ownership of the property by Lindley Patrick. 111

The issuance of bonds in exchange for the bonds of the acquired corporation had been held to constitute an “assumption” within the meaning of the “C” reorganization provisions so as to permit a tax-free exchange. 112 However, the assumption of liabilities must be on the same basis as the existing obligations. If, instead of assuming the same kind or character of liability, the acquiring corporation gives additional security, the result is not merely an assumption by the acquiring corporation of a liability of the other but constitutes the giving of security for the payment of a previously unsecured debt. Consequently, the exchange cannot be treated as one “solely” for the voting stock of the acquired corporation. 113 The modification of the terms of assumed bonded indebtedness as to interest rate on maturity is immaterial even though this constituted an inducement to make the exchange. 114

The area of the substitution of stock options representing liabilities of the acquired corporation has resulted in a number of administrative rulings. The substance of these rulings is that the stock option arrangement of the acquired corporation constitutes contractual liabilities just the same as those which involve the payment of money or other obligations. Accordingly, the undertaking by the acquiring corporation to discharge the acquired corporation’s obligation by sub-

110 315 U.S. 194, 198 (1942).
111 Id. at 199.
112 Helvering v. Taylor, 128 F.2d 885 (2d Cir. 1942).
113 Stoddard v. Comm’r., 141 F.2d 76 (2d Cir. 1944).
114 New Jersey Mortgage & Title Co., 3 T.C. 1277 (1944).
stituting its own stock for that of the acquired corporation was no different than the assumption of a liability under any other executory contract of the acquired corporation. Thus, such substitution was specifically approved in a "C" reorganization.\(^{115}\) A similar result, although under different reasoning, was reached to approve the substitution by the acquiring corporation of its stock options for the outstanding stock options of the acquired corporation in a "B" reorganization.\(^{116}\) The Service ruled that the plan of reorganization required substitution and further required that the acquiring corporation's stock options provided for an increased number of shares subject to the option based upon the same ratio for the conversion of shares in the reorganization exchange.

Although the substitution of options occurred as part of the overall transaction, the acquired corporation's stockholders received solely voting stock of the acquiring corporation as consideration for the stock of the acquired corporation. Stockholders owning the acquired corporation's stock who did not hold any of its options before the transaction did not receive options to purchase stock of the acquiring corporation as a result of the transaction. Since the options contained the same terms as would have applied to the purchase of the acquired corporation's stock under the original stock options, no additional benefits inured to the shareholders on the substitution of the options.

As indicated above, the exchange of its debentures by an acquiring corporation for debentures held by bondholders of the acquired corporation did not constitute indirect non-qualifying consideration in an otherwise qualifying "B" reorganization. In this case the acquiring corporation acquired all of the outstanding debentures in exchange for an equal amount of its identical debentures. Some of the debentures of the acquired corporation were held by its stockholders but a substantial portion of the acquired corporation's debentures was held by persons who held no stock. The Service ruled that the stockholders of the acquired corporation received exclusively voting stock of the acquired corporation as consideration for the exchange of their stock:

The fact that a substantial portion of the Y debentures was held by bondholders who owned no stock in Y had the effect of insuring that the value of the debentures issued by X in exchange for the debentures of Y realistically reflected the value of the Y debentures alone and did not constitute indirect non-qualifying consideration for the Y stock.\(^{117}\)

Although the acquisition by the acquiring corporation of the debentures of the acquired corporation occurred as part of the overall transaction, the Service held that the acquisition of the acquired corporation's debentures for the debentures of the acquiring corporation did not constitute additional consideration for the stock of the acquired corporation. Therefore, such exchange was not a part of the reorganization exchange for purposes of Section 368(a)(1)(B) of the Code.\(^{118}\)


\(^{116}\) Rev. Rul. 70-269, 1970-1 CUM. BULL. 82.

\(^{117}\) Id.

Similarly, the acquisition of debentures for voting stock of the acquiring corporation in a transaction otherwise qualifying as a "B" reorganization will be a taxable transaction with respect to the debentures but will not defeat the "B" reorganization provisions. The Service has held that the acquisition of the debentures in exchange for the voting stock was not part of the reorganization for purposes of the "B" reorganization provisions and for the purposes of Section 354(a)(1).

The participation by two corporations as acquiring corporations may present problems in a "C" reorganization. The Service has ruled that a transaction in which a wholly owned subsidiary acquired all the assets of an unrelated corporation in exchange for its parent's voting stock does not qualify as a "C" reorganization if a part of the liabilities of the acquired corporation are assumed by the parent corporation. Conversely, exactly this result was approved as a "C" reorganization where the parent effected the asset acquisition solely for its voting stock, and as part of the Plan of Reorganization, the assets were transferred directly to the acquiring corporation's wholly owned subsidiary. The decisive difference was that the subsidiary made the acquisition using the parent's stock and then the parent was not the acquiring corporation under Section 368(a)(2) of the Code. Similarly, the Service has ruled that the assumption by a parent corporation of part of the liabilities which had been incurred in the ordinary course of business by an acquired corporation engaging in an "A" reorganization with the parent's wholly owned subsidiary did not disqualify the reorganization.

The Service relied on the language of Sections 368(a)(1)(A) and (a)(2)(D) of the Code which did not contain the limiting language of Section 368(a)(1)(G).

D. Payment of Reorganization Expenses

The stockholder in a closely held corporation may be concerned with the amount of cash which he will have after a reorganization exchange. As indicated above, if he is involved in an "A" reorganization he may receive cash without jeopardizing the nontaxable nature of the exchange. The receipt of cash, however, in the context of a "B" reorganization may jeopardize the entire nontaxable exchange if the receipt of such cash is deemed to be additional consideration for the exchange.

A stockholder's financial position will be the same if instead of receiving cash, he is relieved of the obligation of paying cash. This raises the question of who will pay reorganization expenses. The Tax Court first spoke to this subject in the case of Claridge Apartment Company. The Tax Court held that the payment of costs and disbursements of a bankruptcy reorganization which gave rise to the reorganization did not constitute disqualifying consideration. The Tax Court, relying on the Southwest Consolidated Corp. case, held that such pay-
ments were not such that the nature and amount were determined and fixed in the reorganization. The Tax Court held that such payment did not go indirectly to the acquired corporation. Although the payment constituted part of the costs paid by the acquiring corporation for the property received, they were of a nature characteristic of all reorganizations and normally there is no source of payment for them save the acquiring corporation or its property. Thus, on a practical level, the Tax Court ruled that the payment of such expenses of the reorganization by the acquiring corporation must be permitted to be nontaxable in order to have any reorganization proceeding qualifying as a nontaxable exchange.

The Tax Court in Alcazar Hotel, Inc. held that the forerunner of the “C” reorganization provision permitted the acquiring corporation to pay the expenses of a bankruptcy reorganization in cash. The Commissioner contended that the agreement by the acquiring corporation to pay the expenses incurred in connection with the reorganization proceeding was not such an assumption of liability as is covered by the statute; the liability assumed was not a liability of the acquired corporation, antedating the transaction in question, but was a part of the costs of obtaining clear title to the assets.

The Tax Court in Roosevelt Hotel Co. held that the borrowing of a substantial amount of cash by the acquiring corporation to be placed in escrow to pay the bankruptcy reorganization provisions in a transaction otherwise qualifying as a “C” reorganization would not defeat a nontaxable reorganization. The Court treated the cost of the bankruptcy reorganization in the same way as accrued taxes, accrued interest, and other claims or liabilities of the acquired company including the claims of dissenting bondholders, legal and accounting charges, and expenses of the reorganization. The Court stated:

To the extent necessary to meet the claims of nonassenting bondholder, we may regard a part of the property as set aside for that purpose and not acquired by petitioner. There was cash held by the Trustee sufficient for this purpose, if that be deemed necessary. Petitioner acquired the remainder of the property, substantially all of the property of Hotel Holding Co., and gave as consideration voting stock and the claims of the bondholders non-assenting. Borrowed funds were used to pay the assumed obligation and provide working capital. While this money was borrowed by Petitioner concurrently with the acquisition of the property and placed in escrow to pay the liabilities, the result is the same as though Petitioner had taken the property subject to the liabilities and later borrowed funds to pay the debts. The assumption of a liability of the predecessor or the fact that the property is subject to a liability is to be disregarded under the statute.

The distinguishing feature between this case and Southwest Consolidated Corp. was that the funds in this case were not made available to the dissenting bondholders but were property held by the Trustee, not supplied by the acquiring

125 1 T.C. 872 (1943).
126 Supra note 31.
127 Id. at 408-09.
128 Supra note 18.
corporation. Although the funds were commingled in the escrow, that is one of the mechanics of the transaction the Court regarded as immaterial.

The Service has recently spoken directly to the subject of the effect of the assumption or payment of reorganization expenses. In the pertinent Revenue Ruling, the Service was considering a "C" reorganization. As a part of the plan of reorganization the acquiring corporation agreed to pay or assume certain expenses. These expenses were legal and accounting expenses; appraisal fees; administrative costs of the acquired corporation directly related to the reorganization such as those incurred with printing, clerical work, telephone and telegraph; security underwriting and registration fees and expenses; and transfer agents' fees and expenses. These expenses were solely and directly related to the reorganization. The Service concluded that the payment or assumption of such expenses did not constitute receipt of consideration other than voting stock notwithstanding the fact that the acquired corporation and its shareholders were relieved of the reorganization expenses otherwise attributable to them. The Service ruled that the principles were equally applicable to a "B" reorganization. The Service included in this Ruling a caveat with respect to payments which would constitute expenses which can be paid or assumed:

Expenses that are not solely and directly related to the reorganization, the transfer of the property of the acquired corporation for stock of the acquiring corporation, or the exchange of the equity interest of the shareholders of the acquired corporation for stock of the acquiring corporation, or other property if paid or assumed by the acquiring corporation and will prevent the transaction from satisfying the solely for voting stock requirement of Section 368(a)(1)(B) or (C) of the Code. Examples of such expenses are fees incurred for investment or estate planning advice and those incurred by an individual shareholder, or group of shareholders, for legal, accounting or investment advice or counsel pertaining to participation in, or action with respect to, the reorganization. In addition, where the obligation to pay an applicable State transfer tax is solely that of a shareholder, payment or assumption of such tax by the acquiring corporation will violate the solely for voting stock requirement of Section 368(a)(1)(B) or (C) of the Code.

Further, this ruling is not applicable and the transaction will not qualify under Section 368(a)(1)(B) or (C) of the Code to situations in which there is a transfer by the acquiring corporation of cash or property other than voting stock to the acquired corporation or its shareholders with the intention that the acquired corporation or its shareholders will pay expenses of the acquired corporation or its shareholders even though they are solely and directly related to the reorganization. (Emphasis added.)

The following have been given as examples of valid reorganizational expenses:

The expenses that can arise in effecting a reorganization are many and varied, including preliminary investigation and negotiation expenses; costs of preparing legal documents required to effect the reorganization; finder's

130 Id.
fees; appraisal expenses; legal and accounting fees for preparation of SEC registration statements; fees for audit and preparation of financial statements; costs of proxy statements and the solicitation of shareholders; costs of shareholders' meetings; costs of amending the terms of existing indentures, mortgages and loan agreements; costs of amending the corporate charter; expenses in selling or disposing of unwanted costs; expenses incident in the transfer of assets; legal research bearing on corporate law, tax law, or other legal problems presented by the reorganization plan; costs of obtaining a tax ruling; costs of listing the issued securities on an exchange; charges made by transfer agent; and court costs and other litigation expenses arising out of the reorganization.\textsuperscript{131}

The Service has also spoken directly to the question of stock registration expenses.\textsuperscript{132} This Revenue Ruling covered all reorganizations described in Section 368(a)(1) and held that the payment by an acquiring corporation of costs necessary to register with the Securities and Exchange Commission the stock issued to the stockholders in the reorganization are properly attributable to the acquiring corporation and are not other property received in the reorganization by the stockholders of the acquired corporation. The registration of such shares promotes the orderly marketing of the acquiring corporation to deal with such stock in the same manner as other stockholders of the corporation.

E. Contingent Stock

In any reorganization the exact amount of consideration to be paid for the acquired corporation is subject to negotiation. This is particularly applicable to a closely held corporation. Such negotiations involve items which will not be determined prior to the effective date of the reorganization. Similarly, the value to be assigned to either the stock of the acquiring corporation or the stock of the acquired corporation may not be agreed upon as of the effective date of the reorganization. The exact amount of the liabilities of the acquired corporation may not be known with certainty as of the effective date of the reorganization. If the reorganization is to proceed, some agreement has to be reached with respect to such questions. Generally, the parties agree that the amount of stock to be ultimately issued will be based upon future events: the determination of liabilities, the earnings of either the acquired corporation or the acquiring corporation, and the market value of the stock of the acquiring corporation. Such agreements may result in the receipt of additional stock, generally referred to as "contingent stock." That is, more stock may be issued for the acquired corporation if either its earnings reach a certain prescribed level during a prescribed future period of time or if the value of the stock of the acquiring corporation does not maintain a certain value for a prescribed period of time.

Does the possible receipt of contingent stock disqualify the proposed reorganization because of the requirement that the acquisition be made solely in exchange for voting stock? Generally, the reorganization can be structured so

\textsuperscript{131} B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 5.07 (3rd ed. 1971).
that it will still qualify. A "B" reorganization still qualified even though the plan of reorganization provided for contingent stock because the parties had difficulty in agreeing on the fair market value of the stock of the acquired corporation.\footnote{Rev. Rul. 66-112, 1966-1 Cum. Bull. 68.} The contingent stock was to be issued in each of the succeeding four years following the date of the initial exchange if the acquired corporation’s net income exceeded a specified amount. If the specified amount of net income was not reached in any year, no contingent stock would be issued. The maximum number of contingent shares of voting stock which would be received was 20,000 shares. The right to receive such additional contingent stock was not assignable and such right could give rise to the receipt of only voting stock. The Service ruled that a mere contract right to future distributions of voting stock provided for in the plan of reorganization which is not assignable and which can give rise only to additional voting stock satisfies the "solely for voting stock" requirement of a "B" reorganization.

Also in the context of a "B" reorganization, the Service has ruled that the possible issuance of contingent stock by the acquiring corporation because of a legitimate disagreement as to the value of the acquiring corporation’s stock satisfies the "solely for voting stock" requirement. The parties agreed that the number of shares of additional stock would be determined by a formula based upon the future market price of the shares of the acquiring corporation. In this Revenue Ruling the contingent right to receive the additional voting stock was evidenced only by the plan of reorganization, was not evidenced by a negotiable certificate of any kind, was not readily marketable, and could give rise only to the receipt of additional voting stock. Moreover, the additional stock would be issued no later than four years after the date of the initial exchange. 50,000 shares of voting stock were initially issued and up to an additional 50,000 shares of voting stock could be issued in the future.

That the right to receive contingent stock may be evidenced by voting convertible preferred stock will not necessarily prevent a transaction which otherwise qualifies as a "B" reorganization from qualifying.\footnote{Rev. Rul. 73-205, 1973 Int. Rev. Bull. No. 18, at 33.} Voting convertible preferred stock was issued, which, because of a disagreement as to the value of the stock of the acquired corporation, contained a provision that the number of shares of the acquiring corporation’s stock which could be received would be adjusted based upon a formula using the earning performance of the acquired corporation during the five-year period following the exchange. The right to receive the contingent stock would be forfeited if the voting convertible preferred stock were transferred, other than by operation of law, by the stockholders of the acquired corporation before the time set for the adjustment. After the time set for the adjustment, the exchanging stockholders could transfer the right to receive the additional future stock. 1,000 shares of stock could be initially received and up to an additional 1,000 shares could be received depending upon the earnings of the acquired corporation. In ruling that the preceding transaction qualified as a "B" reorganization, the Service noted:
1) The receipt of additional voting stock was in exchange for the stock of the acquired corporation and not in lieu of any other consideration, such as compensation;

2) The contingent contractual right to receive additional voting stock is not assignable and will be lost if the exchange in stockholders dispose of their convertible preferred stock before the date on which the adjustment in the number of shares would be made;

3) Such right can give rise to the receipt of only additional voting stock of the acquiring corporation; and

4) There was a valid business reason in not issuing all of the stock immediately because of the difficulty in determining the value of the acquired corporation’s stock.138

The receipt of negotiable certificates of contingent interest which do not carry any stockholder rights and which represent a contingent interest with respect to a similar number of common shares of the acquiring corporation constitutes “other property.”136 Such certificates do not have any of the attributes of corporate stock. The certificates of contingent interest would ultimately be converted into voting stock together with cash in an amount equal to the dividends which had been declared on such stock during the time between the reorganization exchange and the delivery of the contingent certificates of beneficial interest. The value of such negotiable certificates of beneficial interest was included in determining the amount of gain realized and recognized on this exchange.

Similarly, the incorporation of the right to purchase additional voting stock, commonly referred to as a “warrant,” in convertible preferred stock in a transaction otherwise qualifying as a “B” reorganization violates the “solely for voting stock” requirement.137

In order to secure protection with respect to the issuance of such contingent stock, the exchanging stockholder should consider obtaining a ruling from the Service. Revenue Procedure 66-34138 and Revenue Procedure 67-13139 discuss the requirements and procedures for obtaining a ruling on the effect on a reorganization involving contingent stock.

The utilization of contingent stock may give rise to an imputed interest obligation under Section 483 of the Code if such stock is to be issued at some future date.140 Interest can be paid in additional stock at a simple annual rate of four (4%) percent without disqualifying a reorganization in order to avoid the five (5%) percent statutory rate. The stock issued representing interest will be taxable as ordinary income at its fair market value when received.141 Both imputed interest and the obligation to pay simple interest can be avoided if the con-
tingent stock is issued, transferred, and delivered in escrow at the exchange. Such shares will be deemed outstanding, and the acquiring corporation may not wish to dilute its earnings per share to that extent until the contingency has occurred.

VII. Miscellaneous: Other Areas of Possible Consideration Problems

A. Introduction

As indicated above, the receipt of any consideration other than voting stock as an inducement for the exchange can defeat the entire nontaxable nature of a "B" reorganization or a "C" reorganization. The questions of the immediate payment of cash and the payment of existing obligations and expenses of the reorganization have already been considered. There are, however, a number of different situations where the Service could assert that the controlling stockholder was acquiring something other than voting stock in exchange for either his stock or the assets of his corporation. Again, other than the possible tax on account on the value of any such items, the stockholder participating in an "A" reorganization or under the limited exception in a "C" reorganization is not confronted with the possible loss of the entire nontaxable exchange.

B. Compensation Arrangements

An area of paramount concern among text writers but which has not been the subject of any judicial interpretations is the possible loss of the nontaxable nature of a reorganization because of the excessive compensation which may be paid to the stockholder of an acquired corporation by the acquiring corporation. The references to this type of transaction in published rulings have all been indirect. For example, in discussing the qualifications of a "B" reorganization involving the issuance of contingent stock, the Service specifically limited the favorable ruling issued therein to situations where the additional stock was not issued as a bonus or compensation to the exchanging stockholders. A similar limitation is contained in Revenue Procedure 66-34 which provides for the issuances of favorable rulings in connection with contingent stock payouts. Here also, the Service restricts its ruling to cases in which the stock is not issued as compensation to an exchanging shareholder.

Although stock received by a shareholder as a bonus or compensation will not be considered to have been received in the reorganization exchange (therefore nontaxable), it does not appear that the receipt of such stock would make the entire transaction taxable. Technically speaking solely voting stock has been received. The consideration for the exchange was "voting stock" whether it was made in exchange for the stock or as a bonus for making the exchange or as a promised consideration for future employment. The bonus or compensatory stock will be taxable to the receiving shareholder at its fair market value.

143 Rev. Rul. 66-112, supra note 133. Interest may be paid in stock without making the exchange taxable. Rev. Rul. 70-300, supra note 141; Rev. Rul. 72-32, supra note 141.
Formal employment agreements between the exchanging shareholder and the acquiring corporation or employment agreements between the exchanging shareholder and the acquired corporation which are guaranteed by the acquiring corporation may be deemed to constitute something other than voting stock. This situation arises where the compensation arrangements provided for in the agreements are excessive and not based upon the payment of reasonable compensation to the exchanging shareholder. Although there are no judicial rulings or even published administrative rulings on this subject, it appears that there is a very real danger that the tax-exempt status of an otherwise tax-free exchange will be jeopardized by excessive compensation arrangements. The Reorganization Branch of the Service is now requiring express representations explaining any increase in compensation over that which an exchanging stockholder-employee of an acquired corporation was receiving from the acquired corporation.\textsuperscript{144} It has been suggested that:

Accordingly, in planning a "B" reorganization or "C" reorganization, the practitioner must caution the parties that any employment contracts with stockholder-employees which are part of the transaction should not provide for compensation more generous than that which they have been receiving from the acquired corporation, unless satisfactory representation may be made in order to explain the raises. Failing such representations, a favorable ruling on the tax-free nature of the reorganization should not be anticipated.\textsuperscript{145}

\textbf{C. Pension Arrangements}

A problem similar in kind to that of the compensation arrangements may be found in non-qualified pension arrangements. A controlling stockholder may determine that in lieu of bargaining for an employment contract to be effective after the date of the exchange, it may be in his best interests to retire. He could, prior to the effective date of the reorganization, cause the acquired corporation to obligate itself to some form of pension arrangement. Such a pension arrangement may constitute an allowable income tax deduction to the acquired corporation based upon either inadequate compensation having been paid in prior years or based upon an established pension arrangement which the company may have demonstrated for other retired employees. At worst, such payments may be determined to be non-deductible by the acquired corporation. So long as this arrangement was not a bargained-for consideration and so long as it was merely shown to be a liability of the acquired corporation existing as of the date of exchange, it does not appear that such an arrangement would constitute property other than voting stock received in consideration for the exchange. It must be noted, however, that the existence of such liability, unless reflected on the financial statements and specifically revealed to the acquiring corporation, could constitute a breach of a representation or warranty with respect to either existing liabilities or existing contractual arrangements.

\textsuperscript{144} 22 Tax Law. 196 (1968).
\textsuperscript{145} Id. at 196-97.
D. Warranties and Indemnifications Provisions

Almost all plans of reorganization contain provisions whereby the acquiring corporation will indemnify the exchanging corporation if certain conditions do not exist. The most significant type of arrangements regarding the issuance of contingent stock have already been discussed. Situations in which indemnification payments may come into play arise in the area of non-disclosed liabilities or overstatement of assets. Typically the plan of reorganization provides that the breach of such representation and warranty will be corrected through the payment of money. It is possible that the payment of such money in the area of an otherwise nontaxable exchange would jeopardize the nontaxable nature of the entire exchange. Again, no cases or administrative rulings have been found on this subject. To avoid any problems it seems to be a better practice to require that any such indemnification payments be made in stock utilizing the fair market value of the stock as of the date of the indemnification payment. Further provisions could be included with respect to the requirement that the stock be freely tradable so as to give the exchanging stockholder the same protection as if money were involved. Since simple interest may be paid in stock without disqualifying a nontaxable exchange, it should be possible to make any other payments in stock.

E. Agreements Not to Compete

Agreements not to compete should be considered in the same light as employment agreements. If the exchanging shareholder is not to continue as an employee of the acquired or acquiring corporation, the acquiring corporation for valid business reasons may desire to prohibit such exchanging shareholder from competing in the future. The safest means of enforcing this prohibition is through the execution of a binding agreement not to compete. With respect to such agreements not to compete, as with employment agreements in general, the question always arises as to the reasonableness of the amount provided. So long as voting stock is used, it appears the worst that can happen is that a portion of the voting stock would be deemed to have been paid for the agreement not to compete and that such amount would be taxable as ordinary income to the exchanging stockholder. If money or other property is used as consideration for such non-competitive agreements, problems arise as to the reasonableness of such amount. Again, in this area, it appears that the utilization of voting stock which is freely tradable and delivered in quantities based upon the fair market value of the stock at specific dates in the future, or at the date of the exchange, would obviate any concern that the Service could at some future time determine that the consideration for the non-competitive agreement was excessive, that it was actually additional consideration for the reorganization, and therefore possibly seek to tax the total amount of consideration received.

146 Supra note 137.
147 Rev. Rul. 70-300, supra note 141; Rev. Rul. 72-32, supra note 141.
VIII. Reorganizations and the Step Transaction Doctrine

A. Introduction

The determination of whether or not a transaction which involves two or more facets will be treated as one transaction or as separate and distinct transactions is solely a question of fact to be adjudicated on a case by case approach. This doctrine has particular significance in the corporate reorganization area because prescribed procedures which if considered separately give one result, may if considered as one unified transaction give an entirely different result.

A valid "B" reorganization was found to exist even though the controlling stockholder had sold two-sevenths (2/7) of the shares of stock in the acquired corporation to the corporation which subsequently became the acquiring corporation.148 The court found that the prior sale was a bona fide sale made prior to any indication that a plan of reorganization was to be adopted. The president of the acquiring corporation, subsequent to the cash acquisition, informed the stockholder of the acquired corporation of the proposed plan of reorganization which provided for the exchange of the acquiring corporation's stock for the stockholder's remaining shares in the acquired corporation. The selling-exchanging stockholder accepted the plan of reorganization on the same day. Indicative of the factual showing which must be made, the court stated:

That this proposal was accepted later in the same day is neither significant nor, as we think, important. There being no challenge to the good faith of petitioner or to the verity of the facts on which she relies, the result would be the same if the two transactions had been thirty or sixty days apart, and we think it certainly would not be contended in the latter case there was but a single transaction involving, as to all 700 shares, an exchange of stock in one corporation for stock and money in another.

The case we have would be wholly different if it appeared the plan was one designed to defeat the payment of taxes. In such a case it would be just as subject to condemnation as was the fictitious transfer of assets by one corporation to another, and thence to the sole stockholder, which, though accomplished in strict conformity with the statute, the Supreme Court denounced in Gregory v. Helvering, 55 S.Ct. 66, 79 L.Ed. 2 (1935).

But here there is not a suspicious circumstance suggesting that what was done was a sham. The sale on the one hand, and the exchange on the other, stand on the admitted facts separate and apart; and as the Supreme Court has said, and as we also have said time and again, in such circumstances the correct rule is to give effect to what actually was done, for that, after all, is the test.149

An excellent example of the application of the "step transaction analysis" as it relates to the reorganization issue is found in the case of South Bay Corporation v. Commissioner.150 The court was required to determine whether or not a series

149 Id. at 444.
150 343 F.2d 698 (2d Cir. 1965).
of steps constituted a reorganization for the purpose of determining the basis of certain property which had been acquired in these transactions. As the court stated:

The "step analysis" of transactions does not operate in terms of an estoppel of taxpayers to deny the forms of their transactions but in terms of the reality of the transaction. (Citation omitted) Where, as here, the transaction presents the determining elements of a change in ultimate ownership and an initial purpose or intention to acquire assets rather than stock as such, each intermediate stage to the final end is not to be given the separate tax significance that belongs only to self-complete business transactions but the full transaction is to be weighed in its overall terms for its tax characterization. (Citations omitted.) The transitory ownership of Collins does not define the transaction as a "reorganization" in the light of the overall change in the significant beneficial interests. (Citations omitted.)

The Tax Court considered the two transactions reorganizations rather than asset purchases because Collins had not acted as petitioner's agent but as a principal (as the Tax Court, properly found) and because the transaction or steps beginning with Collins' stock acquisition and ending with the mergers were not so integrated or interdependent as to be solely for the purpose of petitioner's purchase of assets, particularly since the Court noted that there had been no showing that the properties could not have been acquired by direct purchase (41 T.C. at 903-904). The Court imposed too strict a test in applying the dubious "sole purpose" and "an alternative" tests drawn from the Kimball-Diamond line of cases (citations omitted), to the related but different question of determining whether each one of a set of steps has a separate business completeness, and, therefore, a separate tax significance or is only a part of a single overall transaction for the purpose of assaying its nature as a reorganization or a purchase. The "sole purpose" and "no alternative" language used in the Kimball-Diamond line of cases may be apt guides in determining whether the specific purpose of the whole transaction is, precisely, to acquire assets, as such, and not stock, but it cannot help to resolve the question whether a set of steps resulting in a property acquisition took place by purchase or "in connection with a reorganization." The latter determination is made by now classic standards for analyzing the overall substance of transactions to see whether they reflect a change in ownership or only a change in the form of a continuing ownership, or reflect a union of properties characterized by a continuity of interests of ownership that pre-existed the union of the properties. (Citation omitted.)

That there must be some species of integrating factor to make it rational to define steps as parts of a single transaction is apparent, but it must be doubted that the degree of integration requisite can be, or ought to be, reduced to any rigid formula of integration or interdependence of steps or can, or ought to, go to the extreme of requiring that each step be devoid of business significance unless united with one or more of the other steps. That would import a rigidity of interpretation appropriate only to legislative enactment and inappropriate to the interpretation of a statute that is general in its formulation.151

The step transaction doctrine has been applied in a number of adminis-

151 Id. at 703-04.
trative decisions. A "C" reorganization followed within one month by a redemption of twenty-six (26%) percent of the newly issued stock of the acquiring corporation was not disqualified when the Service determined that there was no preconceived plan and where: (1) the Plan of Reorganization did not mention the cash redemption; (2) there was no commitment prior to the reorganization to consummate the redemption; and (3) there was no agreement by the acquiring corporation to pay cash for the stock. Conversely, the Service ruled that there was no valid "C" reorganization where the cash purchase of stock which immediately preceded an acquisition of assets in exchange for voting stock "was an integral step in a preconceived plan to acquire substantially all of the properties of X."153

B. Distribution of Assets

A particular application of the step transaction doctrine is found in the area of whether or not a prior distribution of assets disqualifies a subsequent reorganization. It may be beneficial, and in some cases essential, that unwanted assets be distributed by the acquired corporation prior to the actual acquisition. The tax consequences of such a distribution under either an "A" reorganization, "B" reorganization, or "C" reorganization must be considered.

The landmark case in this area is Gregory v. Helvering. This case involved the transfer of stock held for investment to a newly created subsidiary in exchange for its stock and then a distribution of the subsidiary's stock to the stockholder of the parent. The subsidiary was liquidated, the investment stock sold, and the taxpayer thereby attempted to convert dividend income into capital gain. In denying nonrecognition of gain treatment to the distribution of the subsidiary's stock, the Supreme Court held that the transaction, although technically within the Congressional language, was alien to the Congressional purpose. The Supreme Court limited the statute's definition of a reorganization to a reorganization of a corporate business or businesses motivated by a business purpose. The Supreme Court found that the creation and liquidation of the subsidiary were only a masquerade for the distribution of an ordinary dividend.

The case of Helvering v. Elkhorn Coal Co. illustrates the judicial reasoning applicable to a "C" reorganization. In Elkhorn, the corporation whose assets were to be acquired distributed to a wholly owned subsidiary certain assets which were not to be transferred in a proposed "C" reorganization. The stock of this wholly owned subsidiary was then exchanged for the stock in the old corporation so that the stockholders of the subsidiary to which the unwanted assets were transferred were, after the subsequent stock exchange, the same stockholders as in the original corporation whose other assets were acquired in the proposed "C" reorganization. Subsequent to this transfer to the newly created subsidiary, the remaining assets of the corporation were exchanged for stock of the acquiring corporation and certain liabilities of the acquired corpo-

152 Rev. Rul. 56-345, supra note 88; see also Rev. Rul. 57-278, 1957-1 CUM. BULL. 124.
154 293 U.S. 465 (1934).
155 95 F.2d 732 (4th Cir. 1938).
RATION were assumed. The stock of the acquiring corporation was promptly distributed by the acquired corporation as a dividend to its stockholders. The exchange of stock by the subsidiary with the stockholders of the old corporation gave those stockholders the same interests in the new corporation that they had had in the old and gave to the new company the ownership of all of the stock in the old. The court determined that the only reason for the organization of the new company was to provide a transferee to take over and hold the assets which were not to be transferred in the proposed "C" reorganization so that the transfer to the acquiring corporation when consummated would be a transfer of all of the assets of the acquired corporation. The court held that this was not a qualified reorganization. The court stated:

Congress has seen fit to grant non-recognition of profit in sale or exchange of assets only under certain conditions, one of which is that one corporation shall transfer "substantially all" of its properties for stock in another. If non-recognition of profit can be secured by the plan adopted in this case, the exemption is broadened to cover all transfers of assets for stock, whether "substantially all" or not, if only the transferor will go to the slight trouble and expense of getting a new charter for his corporation and making the transfer of assets to the new corporation thus created in such a way as to leave in the old only the assets to be transferred at the time the transfer is to be made. We do not think the statutory exemption may be thus broadened by such an artifice. 156

Substantial litigation has arisen concerning the effects of Section 355 of the Code in the area of "spin-off reorganizations." A nontaxable "C" reorganization was found to exist in the case of Commissioner v. Morris Trust, 157 notwithstanding the fact that the distributing acquired corporation went out of existence upon the exchange. This case involved the proposed merger of a state bank and a national bank. To comply with the requirements of the Comptroller of the Currency, the state bank organized a new corporation to which it transferred its insurance business assets in exchange for the new corporation's stock which was in turn immediately distributed to the state bank's stockholders. Thereupon, the state bank merged into the national bank and the national bank was the surviving corporation. Subsequent to this merger both the banking business and the insurance business continued and the former stockholders of the state bank remained in control of the insurance company and of the national bank. The court extensively analyzed the prior judicial and legislative history of Section 355 of the Code and Section 368 (a) (1) (D) of the Code and held that the reorganization provisions may apply successively so that a "D" reorganization may be immediately followed by an "A" reorganization without destroying the nontaxable nature of either transaction. 158

The Service reached a similar result in a transaction culminating in a "B" reorganization. 159 The transaction involved the transfer of the assets constituting

156 Id. at 735.
157 367 F.2d 794 (4th Cir. 1966).
a business which had been actively carried on for five years to a newly created subsidiary and the distribution of the subsidiary's stock to the distributor's stockholders. This transfer was required by a corporation which was negotiating to acquire the other business being carried on by the distributor corporation. Immediately after the distribution, the distributor was acquired in a "B" reorganization. The Service approved this asset reduction and subsequent stock exchange as a valid "B" reorganization and relied only on the solely for voting stock and control requirements of Section 368(a)(1)(B) of the Code.

Under similar facts the Service has ruled that the stock of the newly created subsidiary could not be exchanged in a nontaxable "B" reorganization. This Ruling involved a sole stockholder who, apparently inadvertently (or ill-advisedly), transferred the separate business which was to be acquired by a public corporation for stock to the newly created subsidiary. The subsidiary's stock was immediately exchanged. The Service ruled that the transaction involved a series of integrated steps which could not be considered independently of each other and accordingly the distribution of the subsidiary's stock did not qualify as a "D" reorganization because neither the distributing corporation nor its stockholder was in control of the newly created subsidiary immediately after the distribution; and the stock exchange did not qualify as a "B" reorganization because, in effect, the acquiring corporation exchanged its stock for only a portion of the assets of a previously existing corporation, rather than for all the stock of a previously existing corporation.

C. Incorporation Prior to Reorganization

The "step transaction" analysis has also been applied in connection with the incorporation of a business immediately prior to a reorganization. The transfer of property owned by an individual for stock is not a nontaxable exchange. However, if the individual owned stock in a corporation which owns the property the exchange of the stock or the assets could be a nontaxable exchange as either a "B" reorganization or a "C" reorganization. The Tax Court has ruled that it will apply the "step transaction" doctrine of Gregory v. Helvering in analyzing these situations. In this case both a corporation and its stockholder owned undivided interest in real estate. At a time when a taxable exchange of all these lands for stock in a publicly held corporation was imminent, the stockholder formed a new corporation and caused his corporation to convey its land to the new corporation and he also transferred his land to the new corporation in exchange for stock. The stock of the newly formed corporation was subsequently transferred to the publicly held corporation in exchange for stock and the newly formed corporation was dissolved. The Tax Court held that the new corporation was not organized or used for any bona fide business purpose, and the exchange with the publicly held corporation did not constitute a nontaxable "B" reorganization. The substance of the transaction was a taxable exchange of

160 Rev. Rul. 70-225, supra note 121.
162 293 U.S. 465 (1934).
The two steps of the transaction described above were part of a prearranged integrated plan and may not be considered independently of each other for Federal income tax purposes. The receipt by A of the additional stock of X in exchange for the sole proprietorship assets is transitory and without substance for tax purposes since it is apparent that the assets of the sole proprietorship were transferred to X for the purpose of enabling X to acquire such assets without the recognition of gain to A.

Section 351 of the Code is not applicable to the transfer of the sole proprietorship assets to Y inasmuch as A was not in control of Y immediately after the transfer. The sole proprietorship cannot be a party to a reorganization within the meaning of section 368(b) of the Code. Thus, the transfer of the sole proprietorship assets to X is treated as a sale by A of the assets to Y followed by a transfer of these assets by Y to the capital of X.165

IX. Conclusion

Representing the controlling stockholder of a closely held corporation participating in a nontaxable reorganization can be a very challenging experience. The attorney must strive to protect his client by securing for him adequate compensation for the exchange while still preserving the nontaxable nature of the exchange. This article has discussed the requirements for a nontaxable exchange, the tax consequences of a partially taxable exchange, and special problems which may arise in representing the controlling stockholder. The "A" reorganization affords the greatest flexibility and the smallest possibility of destroying the entire nontaxable exchange. The "C" reorganization is the next most attractive reorganization vehicle and the "B" reorganization is the most restrictive. In any such representation, counsel should consider the desirability of applying for a private ruling. The discussion of the procedure, problems, dangers, and effect of such a private ruling request is beyond the scope of this article. Regardless of whether or not a private ruling will be sought, counsel must know the law, the possible effect of non-compliance, and the problems or other considerations associated with the proposed participation by a controlling stockholder of a closely held corporation in a nontaxable corporate reorganization.

165 Id. at 73.