INCOME TAX CONSEQUENCES OF BOOT IN SECTION 368(a)(1)(B) STOCK FOR STOCK REORGANIZATIONS*

THE Internal Revenue Code generally requires recognition of any gain realized upon a sale or exchange of property.[1] Among the exceptions to this rule is section 354(a)(1), the basic non-recognition provision covering stock-for-stock reorganizations, which provides:

> No gain or loss shall be recognized if stock or securities in a corporation *a party to a reorganization* are, in pursuance of the plan of reorganization, exchanged *solely* for stock or securities in such corporation or in another corporation a party to the reorganization.[2]

Transactions not qualifying for non-recognition treatment under section 354, because of the transfer of consideration other than stock or securities in a party to a reorganization, may qualify for partial non-recognition, however, under section 356(a)(1), the boot provision which applies to stock-for-stock reorganizations:

> If
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> (A) section 354 . . . would apply to an exchange but for the fact that
> (B) the property received in the exchange consists not only of *property permitted by section 354 . . . to be received without the recognition of gain* but also of *other property or money,*[3]
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> then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and their fair market value of such other property.

Section 354 disallows non-recognition of gain to the shareholder transferor in a stock-for-stock exchange for either of two reasons: because property or money in addition to stock of a party to a reorganization is received by the shareholder or because the acquiring corporation whose stock is exchanged is not "a party to a reorganization," as that term is used in section 354. If section 354 does not permit non-recognition because of other property or money, section 356 clearly provides for the partial non-recognition of gain. But where section 354 does not apply because there is no reorganization and therefore the acquiring corporation is not a party to a reorganization, section 356 would seem to be wholly inapplicable, since it requires property permitted by the basic non-recognition provision, section 354. Such property must be stock in a party to

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1. INT. REV. CODE OF 1954, § 1002 [hereinafter cited as I.R.C.].
2. Emphasis added.
3. Emphasis added.

a reorganization. Thus the meaning of "reorganization" is relevant in deciding whether section 356 permits partial non-recognition. Although there are three different kinds of stock-for-stock reorganizations [4] defined in the Code, the application of section 356 has raised particular difficulty in a type "B" reorganization, as defined in section 368(a)(1)(B). This section provides that:

> reorganization means . . . the acquisition by one corporation, *in exchange solely for all or a part of its voting stock,* of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation [5] (whether or not such acquiring corporation had control immediately before the acquisition).[6]

Unlike the other definitions of stock-for-stock reorganizations, section 368(a)(1)(B) expressly disqualifies an exchange consisting of stock of the transferors for both stock and other property of the acquiring corporation, because the consideration received by the shareholders is not solely voting stock.

Such an exchange of both property and stock is outside the purview of section 354, not only because of the solely-for-stock requirement of that section, but also because the stock exchanged by the acquiring corporation is not stock in a party to a reorganization, for the exchange is not a reorganization under section 368(a)(1)(B). This dual effect of the presence of boot would seem to prevent a shareholder from invoking section 356 for partial non-recognition of gain in such transactions, since that provision apparently presupposes the existence of some property permitted non-recognition under section 354, *i.e.,* stock in a party to a reorganization. But this construction of the provisions governing type "B" reorganizations would leave section 356 without a function in these reorganizations, because the transfer of other property would always preclude its application. The problem raised by boot in an exchange which would otherwise be solely of stock-for-stock has been recently considered by the Supreme Court in *Turnbow v. Commissioner.*[7]

The shareholder in *Turnbow* transferred all the shares of his wholly owned corporation, International Dairy Supply Company, to an acquiring corporation, Foremost Dairies. Seventy-one percent of the consideration Turnbow

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4. (A) a statutory merger or consolidation;
(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition); . . .
(E) a recapitalization;
I.R.C. §§ 368(a)(1)(A), (B), (E).

5. Emphasis added.

6. [T]he term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.
I.R.C. § 368(c).

7. Turnbow v. Commissioner, 368 U.S. 337 (1961).

received in exchange for his stock was cash, twenty-nine percent was stock in the transferee corporation.[8] Although the case arises under the 1939 code,[9] the arguments of the Commissioner and the taxpayer are equally applicable to the current provisions of the 1954 Code.[10] The taxpayer, relying on the earlier case of *Howard v. Commissioner*,[11] argued that his $4,163,691.94 [12] gain from the exchange of his stock for stock and cash should not be recognized insofar as it exceeded the $3,000,000 [13] cash received. He maintained that but for the cash received, the exchange would qualify as a "B" reorganization under section 368 and, consequently, it would be an exchange solely of stock in a party to a reorganization under section 354. The transaction, therefore, is within the language of section 356 permitting partial non-recognition whenever section 354 would apply "but for the fact that the property received . . . [consists also of] money." This language in section 356, argued the taxpayer, must authorize the elimination of the cash received by the shareholder in determining whether the exchange is a reorganization under section 368 and in determining whether there is a party to a reorganization under section 354.[14]

Demanding full recognition of the taxpayer's gain, the Commissioner argued that section 356 must be read as limited to transactions where the property received by the shareholder consists "not only of property permitted by section

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8. *Id.* at 338.

9. The relevant provisions under the 1939 code are: INT. REV. CODE OF 1939, ch. 1, § 112(b)(3), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 354(a)(1)):

> No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to a reorganization.

INT. REV. CODE OF 1939, ch. 1, § 112(c)(1), 53 Stat. 39 (now INT. REV. CODE OF 1954, § 356(a)(1)):

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

INT. REV. CODE OF 1939, ch. 1, § 112(g)(1)(B), 53 Stat. 40 (now INT. REV. CODE OF 1954, § 368(a)(1)(B)):

> The term "reorganization" means . . . (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: or 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 . . . .

With respect to the proper interpretation to be accorded to INT. REV. CODE OF 1939, § 112(g)(1)(B), see note 55 *infra*.

10. See note 9 *supra*.

11. 238 F.2d 943 (7th Cir. 1956).

12. Brief for Respondent, p. 3, Turnbow v. Commissioner, 368 U.S. 337 (1961).

13. *Ibid.*

14. Brief for Petitioner, pp. 8-12, Turnbow v. Commissioner, 368 U.S. 337 (1961).

354 . . . but also of . . . money," and that the "not only . . . but also" phraseology clearly indicates that at least a part of the total consideration received must be of a kind permitted by section 354.[15] But where property is received in a stock-for-stock exchange, according to the Commissioner, there can never be a "B" reorganization under section 368 [16] and, consequently, there can never be stock in a party to a reorganization, as required by section 354.[17] Thus section 356 is not applicable, since it requires the receipt of some stock permitted under section 354.[18]

The Supreme Court in *Turnbow* decided in favor of the Commissioner, holding that a reorganization as defined by section 368 is a necessary prerequisite to non-recognition and that section 356 does not authorize an elimination of the cash for the purpose of meeting the solely-for-stock requirement of section 368.[19] The Court pointed out that acceptance of the taxpayer's argument:

> would actually be to permit the negation of Congress' carefully composed definition and use of "reorganization" . . . and to permit non-recognition of gains on what are, in reality, only sales, the full gain from which is immediately recognized. . . .[20]

And the conclusion of the Court was that the statutory provisions are clear on their face.[21] But the problem posed by the language of these sections cannot be so easily resolved. The requirement for partial non-recognition in section 356 of "property permitted by section 354" when read in conjunction with the "solely for stock" prerequisite of section 354 indicates that a literal interpretation of section 356 is not possible.[22] Where cash is received, no property can qualify as property permitted by section 354 since its "solely for stock" condition can never be met. In order for section 356 to allow any partial non-recognition in a reorganization in which both stock and cash are received in exchange for stock, the solely-for-stock prerequisite of section 354 must be ignored for the purpose of determining what property is permitted by that section. For the other stock-for-stock reorganizations, as, for instance, a statutory merger or consolidation, section 356 has, in fact, been so read as to allow elimination of the solely requirement.[23] In order to allow partial non-recognition in

15. Brief for Respondent, p. 17, Turnbow v. Commissioner, 368 U.S. 337 (1961).
16. *Id.* at 15.
17. *Id.* at 17.
18. *Ibid.*
19. Turnbow v. Commissioner, 368 U.S. 337, 343 (1961).
20. *Ibid.*
21. *Ibid.*
22. The Commissioner has nevertheless argued that the relevant sections of the Code are clear on their face:

> What [property permitted by § 112(b)(3)] means, we suggest, is clear beyond doubt, for § 112(b)(3) describes in express terms what property it "permits" to be received without the recognition of gain—namely, "stock or securities in . . . a party to a reorganization."

Brief for Respondent, p. 23, Turnbow v. Commissioner, 368 U.S. 337 (1961).
23. *Cf.* Helvering v. Minnesota Tea Co., 89 F.2d 711 (8th Cir. 1935), *aff'd*, 296 U.S.

a transaction which would qualify as a B reorganization were it not for the receipt of cash by some of the transferor shareholders, however, such an interpretation of section 356 would further require elimination of the soley requirement in the "B" reorganization definition section, which, as the Court correctly concluded, would nullify the definition of a "B" reorganization. The express language of section 356, however, does not reveal whether the "solely for stock" condition in section 368(a)(1)(B) may be ignored in order to allow partial non-recognition; the same inexplicit language has nevertheless authorized deletion of a similar condition in section 354.[24] The language of the statutory scheme thus seems hopelessly ambiguous. But the history of these sections may indicate the application which Congress intended. Though the Court viewed the legislative history of the relevant sections inconclusive, it appears that a reasonably consistent thread of legislative intent is apparent in the pattern of statutory changes since the reorganization provisions were first enacted in 1918.

The first reorganization provision appeared in the Revenue Act of 1918.[25] That act included a single subsection which provided in part that no gain or loss would be recognized when, in connection with a reorganization, merger, or consolidation, a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value.[26] The report of the Senate Finance Committee [27] clearly considered such a transaction as a "purely paper transaction"[28] on which no gain or loss should be recognized. This section was believed to apply only if all the shares of the acquired corporation were transferred.[29] It is not clear whether the requirements of the section would be met, so as to allow partial non-recognition, in cases where the consideration given by the acquiring corporation consisted partly of its own stock and partly of cash.

In the Revenue Act of 1921 [30] the reorganization provisions became considerably more complex. One section [31] of the Act provided that gain would

378 (1935); Commissioner v. Sussman, 102 F.2d 919 (2d Cir. 1939); Commissioner v. Freund, 98 F.2d 201 (3d Cir. 1938); Commissioner v. Owens, 69 F.2d 597 (5th Cir. 1934).

24. See cases cited note 23 *supra*.

25. Revenue Act of 1918, ch. 18, 40 Stat. 1057.

26. When property is exchanged for other property, the property received in exchange shall for the purpose of determining gain or loss be treated as the equivalent of cash to the amount of its fair market value, if any; but when in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities owned by him new stock or securities of no greater aggregate par or face value, no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060.

27. S. REP. No. 617, 65th Cong., 3d Sess. 5-6 (1918).

28. *Id.* at 5.

29. 61 CONG. REC. 6549-50 (1921) (remarks of Senators Jones & McCumber).

30. Revenue Act of 1921, ch. 136, 42 Stat. 227.

31. [N]o gain or loss shall be recognized . . . (2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by

not be recognized where stock in parties to a reorganization was exchanged. That section also defined "reorganization" as an acquisition by one corporation of at least a majority of the shares of the acquired corporation.[32] As a result of permitting an acquisition of less than all the shares of the acquired corporation to qualify as a reorganization, more transactions could receive non-recognition treatment. A partial non-recognition section,[33] the predecessor of the present boot provision, was also incorporated. The latter limited the non-recognition otherwise permitted under the basic non-recognition section, by requiring that, where other property was received, gain on the transaction must be recognized to the extent of the property. Nothing in these sections indicates that the amount of other property which could be received, without disqualifying the entire transaction as a reorganization, was in any way restricted.

The Revenue Act of 1924 [34] established a pattern for the relationship of the basic and partial non-recognition provisions, which are presently sections 354 and 356. The basic non-recognition provision was rephrased and to it was added the requirement, not present in its counterpart in the 1921 Act,[35] that the property received by the shareholder consist "solely" of stock in a party to a reorganization.[36] With this addition, the receipt of cash or other property would be a bar to qualification under the basic non-recognition section. If there was to be any partial non-recognition for the stock received in addition to the boot, the partial non-recognition provision,[37] now section 356, could no longer say, as it

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him, stock or securities in a corporation a party to or resulting from such reorganization. The word "reorganization," as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation (however effected).

Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230.

32. *Ibid.*

33. [W]hen property is exchanged for property specified in paragraphs (1), (2), and (3) of subdivision (c) as received in exchange, together with money or other property . . . other than that specified in such paragraphs, the amount of the gain resulting from such exchange shall be computed in accordance with subdivisions (a) and (b) of this section, but in no case shall the taxable gain exceed the amount of the money and the fair market value of such other property received in exchange.

Revenue Act of 1921, ch. 294, § 202(e), 42 Stat. 1560.

34. Revenue Act of 1924, ch. 234, 43 Stat. 253.

35. Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 230.

36. No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

Revenue Act of 1924, ch. 234, § 203(b)(2), 43 Stat. 256.

37. If an exchange would be within the provisions of paragraph . . . (2) . . . of subdivision (b) if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to

had in the 1921 Act,[38] that the gain on the transaction must be recognized to the extent of the cash or other property received. If it were to continue to perform the same function,[39] this provision had also affirmatively to accord partial non-recognition of gain on property that would otherwise be wholly disqualified by the "solely" requirement. Since the 1924 Congress expressly stated that it did not intend any substantive changes in the relevant reorganization provisions,[40] it seems clear that the partial non-recognition provision[41] was designed to qualify property that was disqualified by the "solely" requirement in the basic non-recognition section.[42] In other words, it was to eliminate the "solely" requirement for purposes of partial non-recognition. The predecessor of section 356[43] could not, however, have been intended to permit elimination of the "solely for stock" requirement from the section defining reorganization,[44] since there was no such requirement at this time.[45]

Under the 1924 Act, a reorganization existed whenever a majority of the stock of a corporation was acquired, no matter how much of the consideration received by the transferor shareholders was property other than stock of the transferee.[46] But the courts believed that the favorable non-recognition treatment accorded to reorganizations was intended by Congress to be applied only to changes in the form of a continuing investment,[47] and not to transactions

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the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

Revenue Act of 1924, ch. 234, § 203(d)(1), 43 Stat. 257.

38. See note 33 *supra.*

39. The committee reports accompanying the 1924 Act indicate that no substantive change in its effect was intended. H. REP. No. 179, 68th Cong., 1st Sess. 14 (1924); S. REP. No. 398, 68th Cong., 1st Sess. 15 (1924).

40. *Ibid.*

41. Revenue Act of 1924, ch. 234, § 203(d)(1), 43 Stat. 257, *supra* note 37.

42. Revenue Act of 1924, ch. 234, § 203(b)(2), 43 Stat. 256, *supra* note 36.

43. Revenue Act of 1924, ch. 234, § 203(d)(1), 43 Stat. 257, *supra* note 37.

44. The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or substantially all the properties of another corporation). . . .

Revenue Act of 1924, ch. 234, § 203(h)(1), 43 Stat. 257.

45. This point was overlooked by the Tax Court in Turnbow, 32 T.C. 646, 651 (1959). In that opinion, the Tax Court cited Luther Bonham, 33 B.T.A. 1100 (1936), as authority for the proposition that § 112(c)(1) (the predecessor of § 356(a)(1)) permitted elimination of the "solely" requirement of § 112(g)(1)(B) (the predecessor of § 368(a)(1)(B)), despite the fact that the word "solely" did not appear in the Revenue Act of 1928, ch. 853, § 112(i)(1)(a), 45 Stat. 818, at the time when this case was decided.

46. See note 45 *supra.*

47. Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-40 (2d Cir. 1932) (acquisition of substantially all the assets of one corporation in exchange for cash and short term notes of the acquiring corporation held not to qualify as a reorganization because the transferor corporation had not retained a continuing interest in the transferred assets). *Accord,* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 470 (1933). See generally Griswold, *"Securities" and "Continuity of Interest,"* 58 HARV. L. REV. 705 (1945).

that appeared to be sales.[48] For this reason, the scope of the reorganization definition was judicially narrowed. Although the requirements for finding a continuing and proprietary interest were never crystalized, a substantial part [49] of the consideration received by the shareholder had to consist of an equity interest in the acquiring corporation.[50] Where the shareholder received mostly cash and some stock in exchange for his stock in the acquired corporation, such transactions were not distinguishable from the ordinary sale of property.[51] In creating the continuity of interest doctrine, which is the equivalent of introducing into the definition of a reorganization the requirement that the transfer of stock by the shareholder must be in exchange for consideration of which a substantial portion is equity stock of the acquiring corporation, the courts did not find the existence of the boot provision an obstacle. The boot provision [52] might permit the elimination of the "solely" requirement from the basic non-recognition section [53] to avoid a bar to non-recognition at that point; but it surely was not a statutory route to escape the judicially created continuity of interest doctrine.

The amendment of the definition of a "B" reorganization in 1934 [54] gave rise to the *Turnbow* problem.[55] Besides increasing the amount of stock acquired

48. Cortland Specialty Co. v. Commissioner, *supra* note 47, at 939.

49. Helvering v. Minnesota Tea Co., 296 U.S. 378, 385 (1935).

50. LeTulle v. Scofield, 308 U.S. 415, 420-21 (1940) (acquisition of all of the assets of one corporation in exchange for cash and bonds of the acquiring corporation held not to qualify as a reorganization because the transferor corporation had not retained a proprietary interest in the transferred assets).

51. Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939 (2d Cir. 1932).

52. I.R.C. § 356(a)(1).

53. I.R.C. § 354(a)(1).

54. Revenue Act of 1934, ch. 277, § 112, 48 Stat. 704.

55. The Internal Revenue Code of 1954 made only one major change in the definition of a "B" reorganization—the addition of the "creeping control amendment," which allows to qualify as a reorganization an acquisition ("in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months") of less than 80% of the stock in the acquired corporation, solely for voting stock of the acquiring corporation, so long as "immediately after the acquisition, the acquiring corporation has control of the acquired corporation" (owns at least 80% of the total combined voting power). I.R.C. § 368(a)(1)(B). Doubt existed under the Internal Revenue Code of 1939 as to whether a previous and unrelated acquisition of stock for cash would disqualify as a reorganization a subsequent acquisition, solely for voting stock in the acquiring corporation, of a controlling interest in the corporation to be acquired. Detailed Discussion of the Technical Provisions of H.R. 8300, 1954 U.S. CODE CONG. & AD. NEWS 4911. *Compare* Dana v. Commissioner, 36 B.T.A. 97, *aff'd*, 103 F.2d 358 (3d Cir. 1939), *with* Pulfer v. Commissioner, 43 B.T.A. 677, *aff'd per curiam*, 128 F.2d 742 (6th Cir. 1942). This doubt appears to be removed by the new "B" reorganization definition, § 368(a)(1)(B). 1954 U.S. CODE CONG. & AD. NEWS 4911. Both the Senate Report and the Treasury Regulations illustrate the operation of the "creeping control amendment" as permitting a subsequent acquisition to qualify for non-recognition following an acquisition, 16 years earlier, for cash. The reference to a 16 year gap between the initial acquisition of stock for cash and the subsequent acquisition of stock for stock strongly implies that in order for the subsequent acquisition to qualify for non-recognition of gain, it must be clearly shown that

by the transferee corporation from a majority to "at least 80 per centum"[56] of the stock of the acquired corporation, the modified definition included the requirement that the consideration received by the transferor stockholders be solely voting stock[57] of the acquiring corporation.[58] This change reflected a

such subsequent acquisition was unrelated to the prior acquisition of stock for cash. 1954 U.S. CODE CONG. & AD. NEWS 4911; Treas. Reg. § 1.368-2(c) (1954).

In view of the suggestion in the Senate Report that twelve months is a "relatively short period of time," 1954 U.S. CODE CONG. & AD. NEWS 4911, an effort may be made by the Internal Revenue Service to apply the "step-transaction" rule to acquisitions for stock and cash which occur within the period of a year. See generally McDonald & Willard, *Tax Free Acquisitions and Distributions*, 14 N.Y.U. INST. ON FED. TAX. 859, 869-75 (1956).

In view of the requirement that a prior cash transaction must be unrelated to a subsequent stock for stock exchange if the later transaction is to be awarded non-recognition, it is clear that the *Turnbow* result cannot be circumvented by any two step transaction separateness of which the taxpayer is unable to prove.

56. The term "reorganization" means . . . (B) 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....

Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 705. Both the stock for stock acquisition and the assets for stock acquisition are here defined in the same subsection; in the 1954 Code, these acquisitions are defined separately in §§ 368(a)(1)(B) and 368(a)(1)(C), respectively.

57. Revenue Act of 1934, ch. 277, § 112(g)(1), *supra* note 56.

58. Under the 1934 Act, it was argued in several cases that only 80 percent of the stock of the acquired corporation need be exchanged solely for voting stock in order to qualify the entire transaction as a reorganization. According to this view of the meaning of the "B" reorganization definition, if 90 percent of the stock of the acquired corporation were exchanged for 8/9 stock of the acquiring corporation and 1/9 cash, the transaction qualified as a reorganization. This argument was not, however, adopted by the courts which held, both as to "B" and "C" reorganizations, that the solely stock requirement applied whether 80 percent, 90 percent, or 100 percent of the total stock or assets of the transferor corporation was acquired. See, *e.g.*, Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942) ("C" reorganization); Helvering v. Cement Investors, 316 U.S. 527 (1942) ("C" reorganization); Central Kansas T. Co. v. Commissioner, 141 F.2d 213 (10th Cir. 1944) ("C" reorganization); Stockton Harbor Industrial Company v. Commissioner, 216 F.2d 638 (9th Cir. 1954) ("C" reorganization); Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir. 1959) ("C" reorganization); Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944) ("C" reorganization); Adwood v. Commissioner, 200 F.2d 552 (6th Cir. 1952) ("C" reorganization); Forrest Hotel Corp. v. Fly, 112 F. Supp. 782 (D. Miss. 1953) ("C" reorganization); Pressed Steel Car Co. v. Commissioner, 13 P-H Tax Ct. Mem. 44-949 (1944), *aff'd per curiam*, 152 F.2d 280 (2d Cir. 1945) ("C" reorganization); Commissioner v. Air Reduction, 130 F.2d 145 (2d Cir. 1942) ("B" reorganization); Howard v. Commissioner, 238 F.2d 933 (7th Cir. 1956) ("B" reorganization); Pulfer v. Commissioner, 43 B.T.A. 677, *aff'd per curiam*, 128 F.2d 742 (6th Cir. 1942) ("B" reorganization). *But see*, Southland Ice Co., 5 T.C. 842, 850 (1945), *acq.*, 1946-1 CUM. BUL. 4. See generally Merritt, *Tax Free Corporate Acquisitions—The Law and the Proposed Regulations*, 53 MICH. L. REV. 911 (1955). The ambiguity in the 1934 Revenue Act appears, however, to have been eliminated in the wording of § 368(a)(1)(B). A comparison of the language of

congressional concern with the tax avoidance possibilities [59] of the previous definition in the 1924 Act,[60] which made it possible for many exchanges which were functionally equivalent to a sale to secure non-recognition treatment.[61] Congress recognized that under the 1924 Act, even after the establishment of the continuity of interest doctrine, exchanges which were, in effect, sales might receive the favorable treatment afforded by the non-recognition provisions.[62] Thus the change introduced in the 1934 Act can be regarded as both a statutory adoption of the continuity of interest doctrine [63] and a simultaneous expansion of its scope.[64] Since the new reorganization definition represented an adoption of the continuity of interest doctrine,[65] Congress presumably intended the new definition to operate as had its judicial predecessor.[66] This would mean that the boot provision should not be interpreted to permit elimination of the solely for voting stock requirement in order to qualify as a reorganization.[67] Any other result would frustrate the purpose of Congress [68] in

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§ 112(g)(1)(B) of the Revenue Act of 1934 and § 368(a)(1)(B) of the 1954 Code makes this clear (emphasis added):

§ 112(g)(1)(B):

> 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* ....

§ 368(a)(1)(B):

> the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of *stock* of another corporation if, immediately after the acquisition, the acquiring corporation has control. . . .

59. Subcommittee on Tax Revision of the Committee on Ways and Means, 73d Cong., 2d Sess., Prevention of Tax Avoidance 34 (Comm. Print 1934); H. REP. No. 704, 73d Cong., 2d Sess. 14 (1934); S. REP. No. 558, 73d Cong., 2d Sess. 16-17 (1934); 78 CONG. REC. 2512 (1934).

60. The term "reorganization" means (A) a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation....

Revenue Act of 1924, ch. 234, § 203(h)(1), 43 Stat. 257.

61. H. REP. No. 704, 73d Cong., 2d Sess. 14 (1934).

62. *Ibid.*

63. 78 CONG. REC. 2512 (1934).

64. *Cf.* Helvering v. Southwest Consol. Corp., 315 U.S. 194, 198 (1942). See *supra* note 58.

65. See note 63 *supra.*

66. See text at note 45 *supra.*

67. The only cases since the 1934 Revenue Act, with the exception of Howard v. Commissioner, *supra* note 11, which raise the problem of whether the predecessor of § 356(a)(1), § 112(c)(1) of the Revenue Act of 1934, requires for its application the existence of a qualifying reorganization are concerned with "D" and "E" type reorganizations which in terms place no limitation on the consideration received in the transaction, and which therefore do not present the problem of *Turnbow* and *Howard* where the presence of cash or boot disqualifies the transaction as a reorganization. I.R.C. § 368(a)(1)(B). Like the pre-1934 cases, however, these "D" and "E" reorganization cases are helpful because they demonstrate the method by which the boot provision has been applied by the courts. See note 45 *supra.* For example, in Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949), the

transferor corporation exchanged its assets, minus excess cash and securities, for voting stock of the new corporation plus an assumption of liabilities of the old company. After the transfer, the old company was liquidated and its assets, consisting primarily of the new company's stock, were distributed to the shareholders. The court determined initially that the transaction qualified as a reorganization under § 112(g)(1)(D) of the Internal Revenue Code of 1939, and went on to hold that the gain on the transfer is recognized to the extent of the boot received under § 112(c)(1). Likewise in the case of South Atlantic Steamship Line v. Commissioner, 42 B.T.A. 705 (1940), the Board of Tax Appeals stated that in order for the taxpayer-stockholder to succeed in his contention that the gain on his exchange of preferred stock in a recapitalized corporation for new stock, bonds, and cash should be recognized only to the extent of the boot, he would first have to establish that the overall transaction qualified as a reorganization. The Board held that the transaction clearly qualified as a "D" reorganization under the Revenue Act of 1936 (I.R.C. § 368(a)(1)(E)), and that the gain should be recognized only to the extent of the boot received under § 112(c)(1). *Cf.* Commissioner v. Estate of Bedford, 325 U.S. 283 (1945); Bazley v. Commissioner, 331 U.S. 737 (1947); Liddon v. Commissioner, 230 F.2d 304 (6th Cir. 1956); Trianon Hotel Co., 30 T.C. 156 (1958) (in which the Tax Court makes the statement in passing that § 112(c)(1) contemplates the existence of a reorganization plan, *id.* at 178).

68. It has been argued, however, that the purpose of Congress would be frustrated if the "solely" requirement cannot be eliminated from the definition section as a prerequisite to applying § 356(c), the boot provision dealing with losses:

> If (1) section 354 would apply to an exchange . . . but for the fact that
>
> (2) the property received in exchange . . . consists not only of property permitted by § 354 . . . to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange . . . shall be recognized.

I.R.C. § 356(c).

It seems clear that the practically identical language of § 356(a)(1), the boot provision dealing with gains, and § 356(c) require that they be applied in exactly the same way. However, if a transaction must independently qualify as a reorganization under § 368 before § 356(c) is applied, then, in an exchange resulting in a loss, the taxpayer-stockholder could easily arrange to have his loss recognized. For if a small amount of boot is injected into what would otherwise be a stock for stock exchange, § 354, which provides for the non-recognition of both gain and loss, would not be applicable, both because the transaction was not an exchange of stock solely for stock and because the transaction did not qualify as a reorganization under § 368(a)(1)(B). Because the transaction did not qualify as a reorganization under § 368, § 356(c) providing for non-recognition of loss in boot transactions could not be applied, and the loss would be recognized. The Seventh Circuit in its opinion in Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956), concluded that it could not possibly have been the intent of Congress to allow the taxpayer the option of having his loss recognized merely by arranging to have a small amount of cash or other property added to the consideration which he or some other stockholder-transferor receives. *Id.* at 948. *Accord*, H. REP. No. 179, 68th Cong., 1st Sess. 15 (1924).

The congressional reports and hearings accompanying the revision of the revenue laws in 1934, however, indicate that Congress was well aware that the reorganization provisions could be easily manipulated in such a way as to have losses recognized. SUBCOMMITTEE ON TAX REVISION OF THE COMMITTEE ON WAYS AND MEANS, 73d CONG., 2D SESS., PREVENTION OF TAX AVOIDANCE 39 Appendix (Comm. Print 1934); *Hearings on H.R. 7835 Before the House Committee on Ways and Means*, 73d Cong., 2d Sess. 75 (1934); H. REP. No. 704, 73d Cong., 2d Sess. 14 (1934). See Commissioner v. Turnbow, 286 F.2d 669, 675 (9th Cir. 1960). As the Ninth Circuit points out in *Turnbow*, Congress appears to have weighed the desirable features of the proposed amendment as to gains against its undesirable potentialities as to losses, and to have elected to make the change. In weighing the possi-

incorporating that requirement.[69] The Court apparently reached this conclusion in *Turnbow,* as indicated by the reference in the opinion to the danger of negating "Congress' carefully composed definition and use of 'reorganization.' "[70]

In addition to the legislative history of the non-recognition [71] and reorganization definition [72] provisions, the scope and focus of these and the related basis [73] provision also support the conclusion that the "solely" requirement in the definition section [74] may not be ignored for the purpose of determining partial non-recognition under section 356. The non-recognition provisions, sections 354 and 356, determine the tax liability of each shareholder who participates individually in an exchange of stock-for-stock; they specify the tax consequences to such shareholders of each exchange. On the other hand the reorganization definition, section 368, speaks in terms of the consideration given by the acquiring corporation to shareholders as a group, and requires that this consideration be "solely voting stock."[75] Thus, under the terms of section 368 (a) (1) (B), a transaction in which all shareholders but one receive solely voting stock, the remaining one receiving voting stock plus boot, would not qualify as a reorganization. The shareholder who receives boot, however, under the view that section 356 authorizes the hypothetical elimination of the cash in determining whether the individual transaction meets the requirements of sections 354 and 368, or, in other words, authorizes the deletion of the "solely" requirement in these sections, would be allowed partial non-recognition of gain, since as to him the transaction is a reorganization. But such a result would create an obviously unintended [76] situation. The shareholders receiving solely voting stock in the same transaction would never fall within section 356, because that section presupposes the receipt of boot by the shareholder individ-

bility of having losses easily recognized in boot transactions, Congress was assured that in no event would such losses be more useful to the taxpayer than are capital losses generally. I.R.C. §§ 1211 & 1212.

69. For a suggestion that courts might be able to overcome the strict "solely for voting stock" requirement of § 368(a) (1) (B) but nevertheless apply the continuity of interest doctrine, see Kanter, *CA-9 Says Boot Makes B Reorganization Impossible: Turnbow Conflicts With CA-7,* 14 J. TAXATION 222, 225 (1961).

70. Turnbow v. Commissioner, 368 U.S. 337 at 343.

71. I.R.C. §§ 354(a) (1) & 356(a) (1).

72. I.R.C. § 368(a) (1) (B).

73. If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on the transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation a party to the reorganization, unless acquired by the issuance of stock or securities of the transferee as the consideration in whole or in part for the transfer.

I.R.C. § 362(b).

74. I.R.C. § 368(a) (1) (B).

75. *Ibid.*

76. See text at notes 47-51, 64-65 *supra.*

ually. Not being within section 356, the transaction as to these shareholders would clearly not be a reorganization for purposes of section 354. Consequently, the gain to those receiving solely stock would have to be fully recognized,[77] despite the unquestionable fact that if the stockholder who received cash was accorded partial non-recognition treatment, the shareholders receiving solely stock should be accorded similar treatment.[78] But there is no statutory argument for the shareholders receiving solely voting stock permitting modification of the reorganization definition in section 368 and the party to a reorganization requirement of section 354.

Allowing non-recognition to those shareholders who are not participants in a reorganization as that term is defined in section 368 would, furthermore, play havoc with the basis [79] provision applicable to such transactions. Where stock is exchanged in a section 368(a)(1)(B) reorganization, the transferor shareholders take the stock of the acquiring corporation with the basis of the stock which they transferred, adjusted to reflect gains recognized and other property and cash received.[80] The acquiring corporation takes the transferred stock at the same basis as it had in the hands of the transferor, increased by the amount of gain recognized by the transferor on the transfer.[81] But where there is no reorganization, both the transferor stockholders and the acquiring corporation take their respective stock at a basis equal to its fair market value.[82] These provisions reflect a clear congressional policy against the acquisition of stock with a stepped-up basis by the acquiring corporation unless the gain on such stock is fully recognized by the shareholder at the time of the transfer. If taxpayers who invoke the terms of section 356 are accorded partial non-recognition of gain despite the failure of the over-all transaction to meet the express terms of section 368(a)(1)(B), the purpose of Congress in framing these elaborate rules for basis would be frustrated. Since the section directing that the acquiring corporation take a low basis applies only where the transaction is a reorganization,[83] the requirements of this provision apparently cannot be modified by section 356. But if a transaction which does not meet the express terms of section 368 can, for the purpose of determining the tax of any transferor stockholder, be considered a reorganization by virtue of section 356, then the transferee corporation takes the stock at a stepped-up basis although the entire gain has not been recognized. Thus the possibility of tax avoidance which the basis section was designed to prevent is resurrected.

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77. I.R.C. § 1002.
78. See text at notes 47-51, 64-65 *supra*.
79. See note 73 *supra*.
80. I.R.C. § 358(a).
81. See note 73 *supra*.
82. I.R.C. § 1012.
83. See note 73 *supra*.

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