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Policy Considerations in the Taxation of B Reorganizations

By JOHN P. STEINES*

A transaction in which one corporation (the "acquiring corporation") exchanges its stock for stock of another corporation (the "acquired corporation") is a "B" reorganization if, after the exchange, the acquiring corporation is in control of the acquired corporation.¹ For federal income tax purposes, B reorganizations are nontaxable to all parties concerned.²

The basic policy underlying this tax-free treatment of corporate reorganizations is that a change merely in the form of a corporate investment should not be a taxable event. A "mere change in form" is shorthand for a continuation of business enterprise and shareholder interest.³ Where these conditions are satisfied, the tax law is neutral; no gain or loss is recognized. This treatment does not permanently eliminate the tax consequences that would attend an outright sale of the corporate investment; it merely postpones them. The taxpayer's basis in the old investment becomes the basis in the new investment.⁴ Gain

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¹ A "B" reorganization is defined as "the acquisition by one corporation, in exchange solely for all or part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition)." I.R.C. § 368(a)(1)(B). I.R.C. § 368(c) defines "control" as 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."

² "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." I.R.C. § 354(a)(1).


⁴ I.R.C. § 358(a)(1).
or loss inherent in the former is accounted for when the latter is disposed of in a taxable transaction. Thus, the reorganization provisions accord tax deferral. Although easily stated, this policy can be very elusive.

For many years the view has prevailed that the transfer of any consideration other than stock of the acquiring corporation, "boot," disqualifies the transaction as a B reorganization. That view is premised upon the word "solely" in the definitional section of the Internal Revenue Code, section 368(a)(1)(B). This requirement, which originated in the Revenue Act of 1934, on its face would appear to limit B reorganizations to pure stock-for-stock exchanges. The argument that "solely" should be interpreted liberally, so that an otherwise permissible B reorganization would not be destroyed by the presence of a small amount of boot, had never succeeded.

In Reeves v. Commissioner, however, the tax court cast doubt on the continued vitality of this inveterate principle. The case involved cash purchases by International Telephone and Telegraph Corporation (ITT) over a four month period of approximately eight percent of the stock of Hartford Fire Insurance Company (Hartford), followed fourteen months later by ITT's acquisition of nearly all of Hartford's remaining stock in a stock-for-stock exchange. Four judges joined in the main opinion holding that the exchange constituted a B reorganization, two concurred in the result under a separate opinion, and five dissented. Three months later, in Pierson v. United States, a refund action involving the same facts, the United States District Court for Delaware agreed with the result in Reeves and squarely departed from prior law in holding that the exchange qualified as a B reorganization. The government appealed the decision to four circuits of the court of appeals, two of which reversed the lower courts' determination as to the construction of "solely," although, remanding on the issue of

5. I.R.C. § 368(a)(1)(B), quoted at note 1 supra.
7. See, e.g., Howard v. Commissioner, 24 T.C. 792 (1955), rev'd on other grounds, 238 F.2d 943 (7th Cir. 1956).
10. 472 F. Supp. at 975.
11. By stipulation of the parties in Reeves and several companion cases, appeals were taken to the First, Third, Fourth, and Ninth Circuits. In a consolidated appeal, both Pierson and Reeves were reversed by the Third Circuit. Heverly v. Commissioner, 80 U.S. Tax Cas. ¶ 9322 (3d Cir. 1980). The First Circuit also reversed the tax court in Reeves. Chapman v.
whether ITT's cash purchases of Hartford stock were part of a plan of reorganization. Unless the remaining appeals are disposed of similarly by the circuit courts, Supreme Court review seems likely; even then the importance of the issue to the administration of federal tax law may warrant certiorari.12

This Article is not confined to the narrow issue, decided in Reeves and Pierson, of how to interpret "solely." It is equally concerned with a number of related issues that continue to cloud the treatment of B reorganizations. Reeves and Pierson, however, do provide a convenient factual backdrop for discussion. The Article considers the meaning of the statutory language a "plan of reorganization," the proper role of the step transaction doctrine, the definition of "solely," "creeping" acquisitions, and legislative reform addressed to confusion caused by each. These subjects are discussed under the direct influence of the policy behind the tax-free treatment of reorganizations, a policy which, as the government's position in Reeves and Pierson demonstrates, too often is lost in the labyrinth of detail that has marked the developing treatment of corporate reorganizations. Only a modest attempt is made to reconcile the remarks herein with possibly conflicting notions expressed in the thicket of cases and rulings dealing with other types of reorganizations.13 A fresh look at the fundamental requirements of a B reorganization, and the reasons for them, is more useful.

Facts and Background of Reeves and Pierson

The transactions culminating in the Reeves and Pierson litigation began in October, 1978, when a representative of ITT approached Hartford's investment banker to suggest the possibility of a merger. Hartford rejected the overture. At about the same time, ITT learned that a six percent block of Hartford stock was available for purchase from a third party. In November, ITT advised Hartford of its interest in acquiring that block, but assured it that ITT would not attempt a

13. Reconciling the B reorganization cases alone is difficult enough. Consider this passage from Vernava, The Howard and Turnbow Cases and the "Solely" Requirement of B Reorganizations, 20 Tax L. Rev. 387, 420 (1965): "It seems, therefore, that Howard and Turnbow can be distinguished and allowed to stand together. Any attempt to distinguish the cases, however, disregards their basically conflicting views on the place of the boot provisions, and on the effect of those provisions in any attempted reorganization." Such talk makes one question the utility of intricate analogy in this area.
hostile takeover. Given that assurance, Hartford did not object to the purchase but reiterated that it had no interest in merging with ITT. Hartford stated that it was considering diversification on its own, but would not take steps that would foreclose a future affiliation with ITT. ITT purchased the six percent block for cash in November.14

On December 23, 1968, ITT submitted a written proposal of merger to Hartford.15 After investigating the proposal, Hartford rejected it and on February 28, 1969, suggested a merger on terms more favorable to its stockholders. ITT made numerous additional cash purchases of Hartford stock, in the meantime, increasing its ownership of Hartford to approximately eight percent by March 13, 1969. Hartford's proposal16 was accepted by ITT and executed on April 19, 1969. The proposal, which remained subject to approval by stockholders of both companies and the Connecticut Insurance Commissioner, gave Hartford the right to withdraw should a probability of antitrust litigation arise.17

In June, 1969, the Department of Justice announced plans to stop the merger. Notwithstanding that threat, Hartford recommended that its stockholders approve the merger. The Department of Justice then moved for an injunction, which was denied in October.18 On October 13, 1969, the Internal Revenue Service issued a private ruling stating that the proposed merger would qualify as a B reorganization if ITT disposed of the stock it acquired for cash before the Hartford stockholders voted on the proposal.19 Shortly thereafter the Service issued a supplemental ruling approving the sale of such stock to Mediobanca, an Italian bank.20


15. ITT's proposal entailed an exchange of ITT stock for Hartford stock, but the precise form of the exchange was left uncertain, the proposal stating only that ITT expected that Hartford would continue as a separate entity. Affidavits in Support of Plaintiff's Motion for Summary Judgment, Pierson v. United States, 472 F. Supp. 957 (D. Del. 1979), rev'd sub nom. Heverly v. Commissioner, 80 U.S. Tax Cas. ¶ 9322 (3d Cir. 1980).

16. This proposal took the form of a reverse triangular merger, of the type described in I.R.C. § 368(a)(2)(E), although that section did not take effect until 1971. The plan called for a newly formed subsidiary of ITT to be merged into Hartford, with the Hartford stockholders exchanging their stock for ITT stock, thereby making Hartford a wholly owned subsidiary of ITT. See Rev. Rul. 67-448, 1967-2 C.B. 144 (treating such a merger as a B reorganization).


20. Id. The purpose of this disposition was to "purge" ITT of Hartford stock acquired
The ITT stockholders approved the merger in June, followed by the approval of the Hartford stockholders did the same in November. In December, however, the Connecticut Insurance Commissioner refused his approval, primarily because the proposed merger forced dissenting Hartford stockholders either to participate in the exchange or exercise their appraisal rights. ITT then proposed to offer its stock on substantially the same terms directly to the Hartford stockholders on a voluntary basis. The Connecticut Insurance Commissioner approved this exchange offer on May 23, 1970, and three days later ITT extended the offer to all Hartford stockholders. Pursuant to that offer, ITT acquired over ninety-five percent of the outstanding Hartford stock, solely in exchange for ITT voting stock.\(^{21}\)

In 1974, shortly before the statute of limitations for the year of the exchange was to expire,\(^{22}\) the Internal Revenue Service retroactively revoked its 1969 rulings that the exchange qualified as a B reorganization and proceeded to assert deficiencies against the Hartford stockholders.\(^{23}\) Over 900 stockholders filed petitions in the tax court; at least one paid the deficiency and sued for recovery in district court.\(^{24}\)

In both the tax court and the district court, the Hartford stockholders moved for a summary judgment on the ground that the 1970 exchange qualified as a B reorganization. To eliminate issues of fact, they conceded for purposes of the motion that ITT be treated as though it still owned the eight percent it purchased for cash, notwithstanding the sale to Mediobanca, and that such cash purchases were made with a

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21. Pierson v. United States, 472 F. Supp. at 960; Reeves v. Commissioner, 71 T.C. at 730-31. Hartford stock acquired in the exchange by ITT consisted of the 8% block previously sold to Mediobanca and approximately 87% of the remaining stock outstanding. Nothing in the record suggests that the original owners of the block sold to Mediobanca retained some Hartford stock and subsequently exchanged it for ITT stock. There is, however, a conceivable overlap between the original owners of the stock purchased by ITT between December 23, 1968 and March 13, 1969 (about 2%), and the owners of the 87% that was exchanged for ITT stock. Given the multitude of Hartford stockholders (over 17,000 participated in the exchange), any such overlap would be negligible, but not without significance to the analysis of B reorganizations in general. See notes 54-57 & accompanying text infra.

22. See I.R.C. § 6501.

23. The rulings were revoked on the ground that ITT allegedly misrepresented and omitted information in its supplemental ruling request on the sale of Hartford stock to Mediobanca. ITT challenged the revocation, seeking a declaratory judgment that the Commissioner exceeded his authority, but the action was dismissed for lack of jurisdiction. International Tel. & Tel. Corp. v. Alexander, 396 F. Supp. 1150 (D. Del. 1975).

24. Sixteen cases were consolidated for decision in Reeves. Reeves v. Commissioner, 71 T.C. at 727 n.l. Pierson apparently is the only refund action that has been filed.
view to acquiring control of Hartford. The taxpayers offered no independent arguments in support of the motion: one, that the cash purchases in 1968 and 1969 were not part of the "plan of reorganization" which culminated in the 1970 stock exchange; and two, that the acquisition of over eighty percent of the Hartford stock solely for ITT stock qualified as a B reorganization, regardless of whether the cash purchases were part of the plan of reorganization. The government maintained that the cash purchases in 1968 and 1969 disqualified the 1970 exchange as a B reorganization.

**Plan of Reorganization**

The tax court and the district court accepted the argument that the 1970 stock exchange satisfied the requirements of a B reorganization notwithstanding ITT's cash purchases, thereby eliminating from consideration the taxpayers' first contention—that the "plan of reorganization" did not encompass the cash purchases. That contention, however, merits discussion here as an alternative ground for appellate review and perhaps as a means of gaining greater insight into the peculiar treatment of B reorganizations.

**Taxpayers' Attempt to Limit the Plan of Reorganization**

The taxpayers framed the issue to involve more than a factual determination of whether the cash purchases should be integrated with the stock exchange under the step transaction doctrine. They maintained that a plan of reorganization includes only specific actions taken by those corporations which are party to the plan and evidenced by formally approved, binding corporate documents. In support of this position they cited numerous cases involving the scope of various plans of corporate restructuring, placing principal reliance on *Commissioner v. Gordon*. *Gordon* involved the distribution of stock in a newly formed subsidiary to stockholders of the parent in a transaction in-

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26. See text accompanying note 79 infra. On appeal, however, the First and Third Circuits in both Reeves and Pierson remanded for reconsideration of this issue. Chapman v. Commissioner, 80 U.S. Tax Cas. ¶ 9330 (1st Cir. 1980); Heverly v. Commissioner, 80 U.S. Tax Cas. ¶ 9332 (3d Cir. 1980).

27. The government agreed that the issue was "primarily one of law." Respondent's Memorandum in Opposition to Petitioners' Motion for Summary Judgment at 3, Reeves v. Commissioner, 71 T.C. 727 (1979), rev'd sub nom. Chapman v. Commissioner, 80 U.S. Tax Cas. ¶ 9330 (1st Cir. 1980).

tended to satisfy section 355,\textsuperscript{29} which accords tax-free treatment to a distribution of at least eighty percent of a subsidiary's voting stock. The Supreme Court held that the distributions, which were made in installments of fifty-seven percent and forty-three percent, separated by twenty-one months, were separate and therefore taxable as a distribution of earnings and profits because the parent was not obligated to make the latter installment.\textsuperscript{30}

\textit{Gordon} is analogous, but only marginally helpful in defining the scope of a B reorganization. Where the parent was not obligated to distribute control of its spun-off subsidiary, \textit{Gordon} properly held section 355 inapplicable, depriving such a distribution of earnings and profits of the tax-free treatment which section 355 is intended to confer only in clear instances of corporate division.\textsuperscript{31} Although tax deferral is the ultimate benefit and objective in both spin-offs and stock-for-stock exchanges, the control requirements of sections 355 and 368(a)(1)(B) serve to deny deferral to basically different types of transactions: section 355 to a distribution of earnings and profits and section 368(a)(1)(B) to a sale, transactions thought to be undeserving of tax-free treatment for different reasons and potentially having greatly disparate tax consequences.\textsuperscript{32} This divergence of concern is sufficient to discount whatever inferential relevance \textit{Gordon} may have to B reorganizations.\textsuperscript{33}

Equally inapposite is \textit{Dunlap & Associates, Inc. v. Commissioner},\textsuperscript{34} also cited by the Hartford stockholders, in which the tax court refused to include the merger of a parent corporation into its newly formed

\begin{itemize}
\item[I.R.C. § 355(a)(1)] provides that a distribution of stock in a subsidiary to stockholders of the parent is not taxable if, among other things, at least 80% of the subsidiary's stock is distributed "as part of the distribution."
\item The plan of reorganization stated that the parent corporation expected to distribute the remaining 43% of the stock within three years at times related to its need for new capital. The Court held that § 355(a)(1)(D) required a "binding commitment" to integrate subsequent distributions with its first installment. 391 U.S. at 96.
\item 31. 391 U.S. at 92-93.
\item 32. Distributions of earnings and profits are taxed as ordinary income under I.R.C. §§ 61, 301, whereas an exchange that fails qualification under § 368(a)(1)(B) is taxed as a conventional sale of property entitled to the preferential treatment of capital gains. I.R.C. §§ 1001, 1201-1202. Treatment of such gain as a dividend under I.R.C. § 356(a)(2) does not apply in a failing B reorganization. See \textit{Turnbow v. Commissioner}, 368 U.S. 337 (1961).
\item 33. Moreover, the Court in \textit{Gordon} explicitly declined to consider whether installment distributions pursuant to a binding commitment satisfy I.R.C. § 355(a)(1)(D), thus impairing the inference that a sale and exchange separated by a time interval are treated separately unless a part of a binding overall plan. \textit{Commissioner v. Gordon}, 391 U.S. at 97 n.11. \textit{Cf.} King Enterprises, Inc. v. United States, 418 F.2d 511, 518 (1969) (discounting inference in \textit{Gordon} that binding commitment is \textit{sine qua non} of step transaction doctrine).
\item 34. 47 T.C. 542 (1967).
\end{itemize}
subsidiary within the same plan of reorganization that encompassed subsequent B reorganizations. In each of the subsequent reorganizations the subsidiary acquired control of other corporations in which the parent had held stock. These B reorganizations, whose purpose was to set the stage for a successful public offering of the subsidiary's stock, were contemplated at the outset but were not certain to succeed. Mutual interdependence, the test applied in *Dunlap*, may have been appropriate for determining whether to integrate the separate forms of reorganization involved there, but there is little to commend its general use as the conclusive determinant of the boundaries of a single B reorganization. The issues simply bear too tenuous a relationship.

35. The issue was whether the taxpayer was entitled to an additional surtax exemption under I.R.C. § 11, which depended on whether the entire series of transactions constituted a single A reorganization, as the taxpayer argued, or an F reorganization followed by separate B reorganizations, as the Commissioner argued. The court agreed with the Commissioner on the ground that the merger—the F reorganization—contemplated, but did not depend on, successful consummation of the subsequent stock exchanges. *See* 47 T.C. at 551.

36. Other cases relied on by the Hartford stockholders for the proposition that a plan of reorganization is limited to mutually binding, corporate obligations (and therefore excludes ITT's cash purchases) entail such different circumstances and considerations that they lend virtually no assistance in setting the parameters of the plan between Hartford and ITT. In *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), stock warrants issued as part of the consideration in a putative C reorganization were held to violate the "solely" requirement in the predecessor of § 368(a)(1)(C), even where they expire unexercised, because the existence of a reorganization is determined as of the date of the exchange. *West Street-Erie Boulevard Corp. v. United States*, 411 F.2d 738 (2d Cir. 1969), permitted a corporation that adopted a plan of liquidation to revoke it when circumstances changed and adopt a substitute plan to begin anew the twelve-month period under I.R.C. § 337. Neither case is helpful in determining whether ITT's cash purchases were part of its plan of reorganization with Hartford.

Nor are United States v. Rodgers, 102 F.2d 335 (3d. Cir. 1939), *modifying* 94 F.2d 666 (3d Cir. 1938), and Bruce v. Helvering, 76 F.2d 442 (D.C. Cir. 1935), of any benefit. The taxpayer in *Rodgers* sold 43% of his stock in a corporation for cash and, pursuant to a simultaneous agreement, exchanged his remaining 57% for stock of the consolidated entity resulting from a merger with the purchasing corporation. In response to the government's argument that gain on all the stock disposed of should be taxed to the extent of boot under the predecessor of § 356, the court treated the cash sale and merger exchange as separate transactions, the former taxable, the latter not. Similarly, the taxpayer in *Bruce* sold 200 shares of stock for cash and later the same day, but pursuant to an entirely new offer unknown to the taxpayer until that moment, exchanged her remaining 500 shares for stock of the purchasing corporation. Again the issue was whether gain on the second transaction was taxable to the extent of boot, and again the taxpayer won, with the court treating the sale and exchange as separate transactions. In neither case did the government dispute the qualification of the second transaction, the exchange, as a reorganization; boot always has been permissible in statutory mergers and was not interdicted in B reorganizations until 1934, well after the years involved in *Bruce*. Rather, the government contended only that gain on the exchange was taxable to the extent cash received, less gain recognized on the concededly taxable sale, a result now precluded in a failing B reorganization by *Turnbow v. Commis-*
Extending the Step Transaction Doctrine

The government’s position in Reeves and Pierson was that the step

sioner, 368 U.S. 337 (1961). For this reason Rodgers and Bruce, although superficially supportive of the Hartford stockholders, are distinguishable.

George L. Riggs, Inc. v. Commissioner, 64 T.C. 474 (1975), held that a corporation’s general intent to liquidate when less than 80% of its stock is owned by a corporate taxpayer does not preclude application of § 332 if the taxpayer’s ownership is increased to 80% before the plan of liquidation is adopted. Like West Street-Erie Boulevard, this case is concerned with timing conditions of favorable liquidation provisions and has only the thinnest connection with the constitution of a B reorganization.

Finally, American Potash & Chemical Corp. v. United States, 402 F.2d 1000 (Ct. Cl. 1968), modifying 399 F.2d 194 (Ct. Cl. 1968), raises an issue very close to that facing the Hartford stockholders but leaves its resolution unclear. The taxpayer acquired 48% of the target company’s stock, solely for its voting stock, in an unsuccessful takeover bid. Fourteen months later it acquired the remaining 52%, again solely for voting stock. Relying on the twelve-month rule in Treas. Reg. § 1.368-2(c) (1955), the court held that the first exchange constituted part of a B reorganization only if both exchanges were part of a “continuing offer” and remedied for trial on that issue. Further confusion is added by a footnote stating that a “different situation” is encountered where the first acquisition is for cash. 402 F.2d at 1001 n.3.

In further support of the position that a plan of reorganization includes only such specific actions, the taxpayers also cited various pieces of legislative history and treasury regulations bearing on the scope of a plan of reorganization. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 806(g)(3), 90 Stat. 1606 (defining adoption of plan of reorganization in terms of formally approved corporate resolutions for purposes of effective date of new loss carryover rules in I.R.C. § 382(b)); H.R. REP. No. 1337, 83d Cong., 2d Sess. A132-33 (1954) (stock acquisitions without “clear connection” treated separately); REPORT OF SUBCOMMITTEE OF HOUSE COMMITTEE ON WAYS AND MEANS, 73d Cong., 2d Sess. (1933), reprinted in J. SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961 at 339 (1938) (plan does not encompass individual shareholder action taken before arrangement of terms); 61 CONG. REC. 6561-66 (1921), reprinted in J. SEIDMAN’S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS, 1938-1961 at 793-94 (remarks of Sen. McCumber on right of majority of stockholders to reorganize); Treas. Reg. § 1.368-3(a) (1955) (requiring formal adoption of plan by each corporation); Treas. Reg. § 1.368-2(g) (1955) (“plan of reorganization” does not broaden definition of reorganization but limits nonrecognition to exchanges directly part of transaction described in § 368(a)); Treas. Reg. § 1.383-3(c)(3) (1975) (same as rule for effective date of loss carryover rules in § 382(b)).

The legislative history is simply too unfocused to be conclusive on the point for which it was offered. The definition of a plan contained in the effective date rules in the Tax Reform Act of 1976 and regulations under § 383 coincides with that offered by the taxpayers, but its purpose was to establish definite indices of when a particular plan was adopted in order to eliminate disputes over whether a reorganization predated the effective date of new law, not to provide a substantive definition of a plan. Similarly, Treas. Reg. § 1.368-3(a) is concerned with recordkeeping and disclosure requirements, not with the substantive determination of what transactions are included within a plan. Treas. Reg. § 1.368-2(g) literally forecloses the construction that a plan of reorganization embraces something broader than the reorganization itself. Whatever the intent of this provision may be, see generally Manning, “In Pursuance of the Plan of Reorganization”: The Scope of the Reorganization Provisions of the Internal Revenue Code, 72 HARV. L. REV. 881, 885 (1959), it cannot mean as a general rule that a written plan describing a B reorganization renders the exchange nontaxable totally without regard to preceding events and understandings. See text accompanying note 48 infra.
transaction doctrine requires inclusion within the plan of reorganization of all acquisitions made after the acquiring corporation's "scheme of action" to acquire is formed. This approach, which would lump ITT's cash purchases with the subsequent exchange and consequently violate the rule against boot in B reorganizations, essentially equates "plan of reorganization" with intent to acquire. A novel theory, it requires more analysis than perfunctory reliance on step transaction cases outside the field of B reorganizations.

Courts frequently have applied the step transaction doctrine to determine whether a series of transactions should be governed by the reorganization provisions. Characterization of the transactions as a particular type of reorganization, or something other than a reorganization, depends on the end result intended by the parties rather than the form of the component steps, traditional substance versus form analysis. The interdependence of the steps and the time lapse between them are important factors as well. The doctrine traditionally is applied in the areas of liquidation-reincorporation, remote continuity-of-interest, and two-step asset acquisition. Such applications produce de-

40. Liquidation of a corporation followed by a planned transfer of substantially all the operating assets to another corporation owned by the same shareholders is collapsed into a single D reorganization, which results in dividend treatment to the extent of earnings and profits retained by the shareholders, rather than capital gain on the liquidation distribution and a stepped-up basis in the reincorporated assets, results that would obtain if the component steps in the overall plan were treated separately. See, e.g., Ringwalt v. United States, 549 F.2d 89 (8th Cir.), cert. denied, 432 U.S. 906 (1977); Davant v. Commissioner, 366 F.2d 874 (5th Cir. 1966).
41. Prior to a string of amendments to I.R.C. § 368 beginning in 1954, the acquiring corporation in a B or C reorganization was not permitted either to effect the exchange by transferring stock of its parent or to transfer the acquired stock or assets to a subsidiary, because the continuity of the acquired corporation's (or its stockholders') interest was considered to be too remote. Helvering v. Bashford, 302 U.S. 454 (1938); Groman v. Commissioner, 302 U.S. 82 (1937). Attempts to circumvent this rule by making a direct acquisition and then transferring the acquired property to a subsidiary in an ostensibly separate transaction were defeated by the step transaction doctrine. E.g., Avco Mfg. Corp. v. Commissioner, 25 T.C. 975 (1956).
42. When a corporation implements a plan to acquire the assets of another corporation by acquiring stock control and then merging with or liquidating the acquired corporation, courts may ignore the separate steps and treat the overall transaction as a direct acquisition of assets. E.g., Kimbell-Diamond Milling Co. v. Commissioner, 14 T.C. 74 (1950), aff'd per curiam, 187 F.2d 718 (5th Cir.), cert. denied, 342 U.S. 827 (1951). See also Levin & Bowen, Taxable and Tax-Free Two-Step Acquisitions and Minority Squeeze-Outs, 33 Tax L. Rev. 425
fensible results, but care must be taken not to extend the doctrine to transactions bereft of attempts to avoid tax or to exalt form over substance—the usual offenses which the doctrine was created to redress.\footnote{43} The precise test employed to determine whether a series of transactions should be treated as an integrated whole varies with the type of transactions involved. Interdependence of the steps in an overall plan may dominate the analysis in one class of cases, whereas the intent of the parties dominates in others, with the decision of whether to integrate possibly turning on which approach is used. The lesson here is that the step transaction doctrine has not been applied uniformly in all types of reorganizations.\footnote{44}

This lesson underscores the simplistic reasoning inherent in the government's conclusory position that all stock acquisitions consummated after the acquiring corporation forms a general intent to gain control of a target company, as manifested in a "scheme of action," must be integrated for purposes of determining the existence of a valid B reorganization. Such an approach fails to take account of the historical purpose and effect of the rule against boot in B reorganizations,\footnote{45} a stricture unique among the various types of acquisitive reorganizations. Moreover, it is without direct judicial support. No case has seriously addressed the issue of whether previous acquisitions of stock for cash destroy a subsequent and otherwise unassailable B reorganization.\footnote{46}

\footnote{43} The doctrine theoretically is applicable whether the result is imposition of, or relief from, taxation. See cases cited in Mintz & Plumb, supra note 37, at 248. As a practical matter, however, the government is usually the party seeking to undo the form of the transactions. \textit{But see}, e.g., \textit{King Enterprises, Inc. v. United States}, 418 F.2d 511 (Ct. Cl. 1969) (doctrine applied in taxpayer's favor to treat taxable stock acquisition followed by merger as a single A reorganization).


\footnote{45} Until the lower court in opinions in \textit{Reeves} and \textit{Pierson}, no case had permitted the presence of any boot in a B reorganization. See text accompanying notes 73-74 infra.

\footnote{46} Prior to 1954, a B reorganization was defined as 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." Internal Revenue Code of 1939, ch. 1, § 112(g)(1)(B), 53 Stat. 40 (current version at I.R.C. § 368(a)(1)(B)). This language was thought to preclude "creeping" reorganizations; 80% of the stock had to be acquired in one bite, solely for voting stock. \textit{But see} Lutkins \textit{v. United States}, 312 F.2d 803 (Ct. Cl), \textit{cert. denied}, 375 U.S. 825 (1963) (dissenting opinion); S. Rep. No. 1622, 83d Cong., 2d Sess. 273 (1954). Thus, creeping stock acquisition cases decided under the 1939 Code, or under similar provisions in effect before 1939, do not support application of the step transaction doctrine in creeping B reorganizations under the 1954 Code. The pre-1954 cases finding against a B reorganization do not
Reasoning by analogy from cases involving other types of reorganizations that the step transaction doctrine is applicable in stock-for-stock exchanges such as the Hartford-ITT exchange thus, is not necessarily correct. Furthermore, the step transaction doctrine should not be regarded as a self-operating rule of law with independent content. Its proper function should be to pierce formality only where necessary to preserve the integrity of statutory rules or to prevent form from camouflaging substance; its content should derive from those rules. The doctrine should not be used to bootstrap preconceived views of what constitutes a proper result. Nor should it supplant interpretation of specific statutory language, no matter how difficult, in light of relevant policy considerations. The ultimate issue is not whether the step transaction doctrine applies, but whether the apparent consequences of particular transactions violate a statutory rule or policy. The inquiry is hardly satisfied by an incantation of the step transaction doctrine.\footnote{\textsuperscript{47}}

hinge on integration of the exchange with previous cash purchases flowing from an ultimate intent to gain control.

In Pulfer v. Commissioner, 43 B.T.A. 677 (1941), the acquiring corporation purchased 69\% of the acquired corporation's stock in 1921 and acquired nearly all the remaining 31\% in 1935, solely for its voting stock. Without making any attempt to link the purchase with the exchange, the Board summarily held that 80\% was not acquired solely for voting stock.

The acquiring corporation in Commissioner v. Air Reduction Co., 130 F.2d 145 (2d Cir.), \textit{cert. denied}, 317 U.S. 681 (1942), purchased 6\% of the target company's stock and acquired 66\% in exchange for its voting stock before 1935. During 1935 it purchased an additional 12\% and acquired the remaining 16\% in a stock-for-stock exchange. Disposing of a subsidiary issue to which it devoted only three sentences, the court concluded that the cash purchases disqualified the 1935 exchange from being solely for voting stock. The opinion intimates no factual basis for integrating the purchases with the exchange, nor even mentions the step transaction doctrine. In Lutkins v. United States, 312 F.2d 803 (Ct. Cl.), \textit{cert. denied}, 375 U.S. 825 (1963), the acquiring corporation exchanged its voting stock for 65\% of the target company's stock in 1912, and purchased an additional 3\% in numerous market transactions between 1929 and 1951. In 1952 it acquired an additional 30\% solely for its voting stock. Interpreting the 1939 Code to require acquisition of 80\% in a single transaction, the court held that the acquisition of 30\% in 1952 was not a B reorganization. It added parenthetically that the cash purchases were unrelated. 312 F.2d at 805.

Had the acquiring corporations in \textit{Pulfer}, \textit{Air Reduction}, and \textit{Lutkins} not made the cash purchases, their exchanges would have failed as B reorganizations nonetheless, for none satisfied the then-existing definition of a B reorganization. Furthermore, \textit{Pulfer} and \textit{Lutkins} reject any factual basis for the step transaction doctrine, and \textit{Air Reduction} is silent on the point. See the discussion of \textit{Bruce} and \textit{Rodgers} at note 36 supra.

Of the B reorganization cases, only Howard v. Commissioner, 24 T.C. 792 (1955), \textit{rev'd on other grounds}, 238 F.2d 943 (7th Cir. 1956), links proximate cash purchases with the exchange at issue under step transaction rubric. And there, unlike the Hartford-ITT exchange, the purchases and exchange were simultaneous and pursuant to a single written agreement negotiated by an individual acting on behalf of all stockholders of the acquired corporation. See note 81 infra.

\textsuperscript{47} \textit{Cf.} Rubin v. Commissioner, 429 F.2d 650 (2d Cir. 1970) (rejecting application of judicial doctrine in lieu of §482 in an analogous situation). In \textit{Rubin}, the court concluded: “Resort to section 482 is clearly superior to the blunt tool employed by the Tax Court.
A Reasonable Definition of Plan of Reorganization

Significantly, the term "plan of reorganization" does not appear in section 368(a)(1)(B)'s definition of a B reorganization, but rather in section 354(a)(1), which accords nonrecognition of gain or loss to exchanges of stock "in pursuance of the plan of reorganization." The Code's segregation of definitional and operative provisions and its confinement of the broader "in pursuance of the plan" language to the latter, suggest that not every transaction connected with a putative reorganization must be considered to determine if a reorganization actually occurs. Without placing undue emphasis on this textual distinction, there is no dispute, for example, that neither B nor C reorganizations definitionally require liquidation of the target company; yet such a liquidation, if intended as part of the overall plan, is nontaxable by virtue of its connection with the reorganization. Treatment of the liquidation is governed by section 354(a)(1) without reference to the definitions in sections 368(a)(1)(B) and (C). If the liquidation does not have a sufficient factual nexus with the reorganization, its consequences are determined under the liquidation provisions of the Code without negating the reorganization.

Analogous reasoning applies to a stock-for-stock exchange accompanied by a proximate cash purchase of stock of the target company.

References to 'substance over form' and the 'true earner' of income merely restate the issue in cases like this: Who is the 'true earner'? What is substance and what is form? Moreover, they do so in a way which makes it appear that these questions can be answered simply by viewing the facts with appropriate suspicion. The language of § 482 more clearly commands analysis of the facts in terms of the competing policies outlined above." Id. at 653.

48. 48 I.R.C. § 354(a)(1)
51. See Rev. Rul. 57-518, 1957-2 C.B. 253 (assuming that liquidation of the acquired corporation immediately following a C reorganization is nontaxable despite § 331); Rev. Rul. 67-274, 1967-2 C.B. 141 (treating liquidation of the acquired corporation following a B reorganization as tantamount to a C reorganization and thus nontaxable).
53. Distant purchases present no problem under the step transaction doctrine. They
by the acquiring corporation. Absent an attempt to use the form of section 368(a)(1)(B) to avoid taxation of an exchange which otherwise would be taxable, no proper purpose is served by letting the purchase disqualify the exchange as a reorganization. Certainly the Code does not require this result. In this instance, proximate stock sales should be treated outside the plan of reorganization, as if totally unrelated. The key to this analysis, as the following situations illustrate, lies in the makeup of the respective target company stockholders participating in the exchange and the sale.

**Situation #1.** If the overlap between stockholders of the target company who participate in both the sale and the exchange is sufficiently low that the stockholders participating only in the exchange had control of the acquired corporation, destruction of the B reorganization would be caused exclusively by transactions between the other stockholder group and the acquiring corporation. Those were the facts in the Hartford-ITT exchange. Regardless of whether the stockholders receiving only stock are aware of previous cash sales by other stockholders, no basis exists for a charge of tax avoidance or using form to conceal substance. The exchange group could have effected a B reorganization on its own with the acquiring corporation. Infesting such an exchange with transactions between other parties under step transaction rubric is unwarranted. However the step transaction test might be verbalized, some degree of mutual intent should be indispensable to its application. To stockholders who receive only stock of the acquiring corporation, cash sales by other stockholders are a matter of indifference and should be immaterial for tax purposes as well.

In contrast, stockholders who receive only cash would be outside the plan of reorganization and would have to recognize gain or loss. A more difficult question, however, concerns the treatment of stockholders who receive both cash and stock. Taxation of their gain to the ex-

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54. See note 1 supra for the definition of “control.”

55. *Cf.* I.R.C. § 351(a) (nontaxable exchange where transferor group has control).

56. *But cf.* King Enterprises, Inc. v. United States, 418 F.2d 511 (Ct. Cl. 1969) (doctrine applied in favor of shareholder who was not party to overall plan).

tent of cash received under section 356 would be an acceptable result, but is foreclosed by the rule that the presence of any boot destroys a B reorganization and consequently renders section 356 inapplicable. The trial court opinions in Reeves and Pierson may have cast doubt on the continued validity of that rule, but until their approach gains acceptance, the plan of reorganization issue will have continuing significance.

If stockholders participating in the sale have knowledge of the acquiring corporation’s intent to consummate an exchange and subsequently participate in that exchange, granting them nonrecognition in the latter transaction creates tax avoidance potential. But excising their sale from the plan of reorganization and nonetheless treating their participation in the exchange as a taxable event is worse, for in effect it would make the existence of a B reorganization a stockholder-by-stockholder inquiry. Not only would this complicate both the ruling process and the task of representing the consequences of a proposed exchange but, more importantly, it also would add another layer of confusion to an already perplexing area. Limiting the separate treatment of cash sales to situations in which those stockholders participating only in the exchange have control of the target company sufficiently minimizes tax avoidance potential.

Situation #2. The foregoing thesis could even be extended to situations in which stockholders participating only in the exchange do not have control of the target company. In such a case, a B reorganization could not take place unless stock held by that group plus stock exchanged (not sold) by shareholders participating in both the sale and exchange equalled at least eighty percent of the target company’s stock. Admittedly, the equities in favor of the former group are less compelling if

58. "If section 354 . . . would apply to an exchange but for the fact that 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, 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.” I.R.C. § 356(a)(1).
60. Of course no such potential exists where the stockholders do not have knowledge of the acquiring corporation’s plans; courts have no difficulty rejecting the step transaction doctrine in that circumstance. See note 36 supra (discussing Bruce v. Helvering).

Moreover, tax avoidance is a dubious criterion for resolving reorganization issues. The reorganization provisions openly encourage partial tax avoidance through deferral; to withhold the benefit of deferral because one carefully structures his or her affairs to achieve it seems paradoxical. Less mysterious means are available to protect the revenue. See generally Gunn, Tax Avoidance, 76 Mich. L. Rev. 733 (1978).

61. This assumes, for simplicity, that the acquiring corporation owned no stock in the target company before the proximate purchase and exchange. If that is not the case, stock
that group does not own sufficient stock on its own to transfer control of the acquired corporation. The availability of nonrecognition in exchanges of infinitesimal amounts of stock afforded by the present treatment of "creeping" B reorganizations, however, aptly illustrates the anomaly of taxing the exchange of a significant amount of stock merely because other stockholders recently sold part of their stock for cash.\footnote{62}

Using the term "plan of reorganization" to separate a stock-for-stock exchange from proximate stock sales seems particularly appropriate in reorganizations of publicly held corporations. The ubiquitous presence of government, the required formality, the anonymity of parties, and the resistance to acquisition that so often exist in public mergers all operate to minimize the potential for manipulating form that inheres to a greater degree in dealings with closely held corporations. ITT's tax counsel certainly knew at the time the cash purchases were made that the Internal Revenue Service might integrate them with a subsequent stock exchange.\footnote{63} The probable fact is that ITT, confronted with resistance from Hartford and the Department of Justice, was not then concerned as much with the precise form of what proved to be a difficult acquisition as with its chances of merging in any form.\footnote{64} It did not know at the outset that its plan of merger would succeed and that it would then purchase stock for cash and cleverly omit the purchase from its formal plan of reorganization with Hartford. A variety of exigencies having nothing to do with tax considerations might explain why the acquisitions in 1968 and 1969 were for cash instead of ITT stock. The ultimate form of the exchange was dictated by action taken by the Connecticut Insurance Commissioner nine months after ITT's last purchase was consummated.\footnote{65} Denying qualification of the exchange as a B reorganization on the basis of ITT's historical intent to acquire is a specious application of the step transaction doctrine. Such...
an application seemingly ignores the events leading up to the exchange and imposes the most significant consequences on the Hartford stockholders, the taxpayers least able to control ITT's "tainted" state of mind.66

Given this perspective, the Hartford stockholders seem correct in their assertion that the plan of reorganization between Hartford and ITT should be limited to the terms of the written agreement between the companies. Nothing in the policy of the reorganization provisions warrants an interpretation that straitjackets the form in which acquisitions must develop. Acquiring corporations should have the initial flexibility to probe a takeover possibility in whatever manner seems most reasonable, without jeopardizing the treatment of a subsequent reorganization. The "plan of reorganization" language is an appropriate tool for implementing flexibility.

Despite the appeal of this approach in the Hartford-ITT exchange, one can imagine situations involving closely held or semiprivate corporations in which the rule would produce questionable results. Suppose Corporation $A$, a public company, wants to acquire all the stock of Corporation $B$, seventy shares of which are owned by $X$ and thirty by $Y$. $X$ is happy to accept Corporation $A$ stock, but $Y$ wants to sell out for as much cash as possible. $Y$ then sells twenty shares to Corporation $A$ for cash and subsequently exchanges the remaining ten shares, along with $X$'s seventy shares, solely for Corporation $A$ voting stock. This is the second situation discussed above.67 Should $Y$ escape tax on the ten shares exchanged for Corporation $A$ stock? Probably not, but that would be the result if the cash sale was excised from the "plan of reorganization." This concern over a wooden separation of sales proximate to the acquisition of a closely held company is not meant to suggest a different definition of "plan" for private companies, but rather, merely to recognize the greater opportunity for manipulation. Thus, even an interpretation that is beholden more to policy than to step transaction criteria can be problematic. A very cautious and sparing use of the step transaction doctrine might be a preferable solution under the present statutory framework. One hardly can be optimistic about such a prospect, however, in view of the government's zeal in Reeves and Pierson.

66. ITT agreed to provide counsel for the Hartford stockholders and to indemnify them for tax liability resulting from the exchange being treated as a taxable event. This fact, however, should be irrelevant to the determination of their tax consequences. But cf. Montana v. United States, 440 U.S. 147 (1979) (United States estopped from challenging in separate action adjudication against third party on same issue in previous litigation financed and directed by United States).

67. See notes 61-62 & accompanying text supra.
Of course dependence on the meaning of such fluid words as “plan of reorganization” would be obviated by an interpretation of “solely” in section 368(a)(1)(B) that allowed for the transfer of a relatively small amount of boot in a B reorganization. An elastic definition of a plan is necessary only to maintain some semblance of equilibrium with the heretofore rigidly literal judicial interpretation of “solely.” Although the Hartford stockholders hardly can be faulted for presenting two theories to support finding a B reorganization, in reality the two theories are so interrelated that meaningful analysis of one, without reference to the other, is impossible. Perhaps that is why the main opinion in Reeves conditions its resolution of how “solely” is interpreted on the factual premise that the stock exchange stood apart from the previous cash purchases. That premise, however, is indistinguishable from the taxpayers’ plan of reorganization argument, which the court purported not to decide.

“Solely” for Voting Stock

As stated at the outset, the policy supporting tax-free treatment of corporate reorganizations is that a change merely in the form of a corporate investment should not be a taxable event; rather, tax consequences should be deferred until a more substantial change in the investment occurs. Thus, tax law does not act as a barrier to legitimate restructuring of corporate ownership. Subsumed within this policy is the notion that the privilege of tax deferral should be available only where an acceptable percentage of the owners of the acquired corporation continue as owners of the acquiring corporation. This continuity-of-interest doctrine was fashioned by the courts during the formative years of the reorganization provisions to deny deferral where continuity of ownership was deemed insufficient. A concern of the same general nature moved Congress to insert “solely” into the definition of a B reorganization in the Revenue Act of 1934, to assure that at least eighty percent ownership in the acquired corporation was transformed by the reorganization into ownership in the acquiring corporation.


69. Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 705 (1934) (current version at I.R.C. § 368(a)(1)(B), (C)). The text of this section as it relates to a B reorganization is substantially identical to its successor in the Internal Revenue Code of 1939, quoted at note 46 supra.

70. See S. REP. No. 558, 73d Cong., 2d Sess. 16-17 (1934), reprinted in 1939-1 (part 2) C.B. 598-99; H.R. REP. No. 704, 73d Cong., 2d Sess. 12-14 (1934) reprinted in 1939-1 (part 2)
The addition of "solely" may be viewed simply as a quantified codification of the continuity-of-interest doctrine in B reorganizations71 and should be interpreted accordingly.

Much has been written in support of a liberal interpretation that would allow a B reorganization in a transaction in which eighty percent of the target company's stock is acquired solely for voting stock, regardless of the type of consideration used to acquire any additional stock.72 Before the lower court decisions in Reeves and Pierson, however, an uninterrupted line of decisions had interpreted "solely" as an absolute interdiction of boot in a B reorganization.73 Notwithstanding that history, both trial courts regarded application of the tenet to the Hartford-ITT exchange as a case of first impression. Cases giving rise to the antiquated assumption that the slightest amount of boot destroys a B reorganization were distinguished on the factual ground that none involved a single, boot-free acquisition of eighty percent of the target company's stock.74

The opinions carefully trace the path by which "solely" acquired its reputed content and persuasively chip away the foundation. The admonition that "solely leaves no leeway" originated in Helvering v. Southwest Consolidated Corp.,75 an assets acquisition case in which boot comprised thirty-seven percent of the consideration. Subsequent decisions cursorily assumed the aphorism to be equally applicable in stock acquisitions,76 despite the existence of variant considerations and

C.B. 563-65. These reports reveal congressional concern over the tax-free treatment of what essentially were disguised sales. "Soely" provided an objective distinction between "reorganizations" laced with too much boot and those possessing sufficient continuity.


73. Turnbow v. Commissioner, 368 U.S. 337 (1961), aff'd 286 F.2d 669 (9th Cir. 1960); Lutkins v. United States, 312 F.2d 803 (Ct. Cl.), cert. denied, 375 U.S. 825 (1963); Commissioner v. Air Reduction Co., 130 F.2d 145 (2d Cir.), cert. denied, 317 U.S. 681 (1942); Mills v. Commissioner, 39 T.C. 393 (1962), rev'd on other grounds, 331 F.2d 321 (5th Cir. 1964); Howard v. Commissioner, 24 T.C. 792 (1955), rev'd on other grounds, 238 F.2d 943 (7th Cir. 1956); Pulfer v. Commissioner, 43 B.T.A. 677 (1941). For a discussion of the facts in Air Reduction, Lutkins, and Pulfer, see note 46 supra.


75. 315 U.S. 194 (1942).

76. The law applied in Southwest Consolidated treated B and C reorganizations in a
a developing statutory lenience toward boot in assets acquisitions.  

Furthermore, much of *Southwest Consolidated*'s progeny in the B reor-

single paragraph, each subject to the same "solely" requirement. Revenue Act of 1934, ch. 277, § 112(g)(1)(B), 48 Stat. 705 (codified at I.R.C. § 368(a)(1)(B), (C)). An amendment to the Internal Revenue Code of 1939 separated B and C reorganizations into § 112(g)(1)(B) and (C), with separate "solely" requirements, the latter permitting the acquiring corporation to assume the acquired corporation's liabilities. Internal Revenue Code of 1939, ch. 247, 53 Stat. 870 (current version at I.R.C. § 368(a)(1)(B), (C)). Only Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960), aff'd, 368 U.S. 337 (1961); Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956); and Mills v. Commissioner, 39 T.C. 393 (1962), rev'd on other grounds, 331 F.2d 321 (5th Cir. 1964), have seriously considered the applicability of *Southwest Consolidated* to B reorganizations.

77. In addition to the 1939 amendment allowing the acquiring corporation to assume the acquired corporation's liabilities in a C reorganization, see note 76 supra, I.R.C. § 368(a)(2)(B) was enacted in 1954 to permit up to 20% boot in a C reorganization. The trial courts in *Reeves* and *Pierson* thought these retreats from a strict interpretation of "solely," combined with statutory changes in the definition of a B reorganization in 1954 (permitting creeping reorganizations) and again in 1964 (permitting use of parent's stock) that did not tamper with the "solely" requirement, plausibly suggested that Congress never understood the rule in *Southwest Consolidated* to be applicable to B reorganization. This mind-reading is buttressed by language in the regulations underlying § 112(g)(1)(B) of the 1939 Code, see note 46 supra, which indicates boot may be used to acquire stock in excess of 80%: "In order to qualify as a 'reorganization' under section 112(g)(1)(B), the acquisition by the acquiring corporation of the required amount of the stock of the other corporation must be in exchange solely for all or part of the voting stock of the acquiring corporation. If for example Corporation X exchange non-voting preferred stock or bonds in addition to all or a part of its voting stock in the acquisition of the required amount of stock in Corporation Y, the transaction is not a 'reorganization' under section 112(g)(1)(B)." Treas. Reg. 111, § 29.112(g)-2 (1942) (emphasis added). And in 1964, in its deliberation on the amendment allowing use of the parent's stock in a B reorganization, Congress stated that B and C reorganizations should be treated the same. S. REP. No. 1533, 91st Cong., 2d Sess. 2-3 (1970) (accompanying enactment of § 368(a)(2)(E) and stating that no stock may be acquired for cash in a B reorganization).

The utility of legislative history in divining whether Congress would have thought the Hartford-ITT exchange qualified as a B reorganization deserves comment. One writer argued that the lower court holding in *Reeves* was unwarranted by legislative history, on the strength of history which either is concededly inconclusive or accompanies the enactment of a provision not even in force when the exchange in *Reeves* occurred. Comment, *The "Solely for Voting Stock" Requirement of B Reorganizations: Reeves v. Commissioner*, 79 COLUM. L. REV. 774, 792-96 (1979). In reality, no one knows what Congress intended because Congress never said; all one can do is guess. Basing the guess on isolated statements in reports which relate to other provisions of the Code is questionable. Where history is inconclusive or only tenuously related to a particular question, a frank admission to that effect is preferable to scrutinizing felicitious words for hidden meaning which the authors either didn't contemplate or carefully consider.  

ganization area involved creeping acquisitions, a technique not permitted under pre-1954 law irrespective of the "solely" issue.\textsuperscript{78} Dissatisfied with inadequate judicial analysis, and finding refuge in the Supreme Court's veiled intimation in \textit{Turnbow v. Commissioner}\textsuperscript{79} that the issue should be reconsidered, the trial courts in \textit{Reeves} and \textit{Pierson} considered themselves unconstrained by precedent. Recognizing that the issue was not free from doubt, and unable to identify a policy that nonrecognition would violate where eighty percent of the acquired corporation's stock is exchanged solely for voting stock, they held that the Hartford-ITT exchange satisfied section 368(a)(1)(B).

The holdings differ, however, in one important respect, which can be explained best in connection with \textit{Howard v. Commissioner},\textsuperscript{80} the most troublesome case for the Hartford stockholders. Truax-Traer Coal Company acquired all the outstanding stock of Binkley Coal Company in a single transaction, over eighty percent for stock and the rest for cash.\textsuperscript{81} The transaction was denied reorganization status because it was not solely for voting stock; the same argument made by the Hartford stockholders that eighty percent for stock is sufficient was rejected. Both the \textit{Reeves} and \textit{Pierson} trial courts distinguished \textit{Howard} on the ground that the Hartford-ITT exchange in 1970 was free of boot.\textsuperscript{82} \textit{Pierson}, however, proceeded to reject \textit{Howard} squarely, holding that section 368(a)(1)(B) is satisfied where eighty percent of the acquired corporation's stock is exchanged solely for voting stock, regardless of the type of consideration used to acquire any additional stock in the same transaction. That is also the position taken in the concurring opinion in \textit{Reeves}. The main opinion in \textit{Reeves}, however, reserved judgment on the vitality of \textit{Howard} and conditioned its holding on a factual premise that distinguishes \textit{Howard}, namely, that the 1970 stock exchange was a single transaction standing apart from the cash purchases in 1968 and 1969.

\textsuperscript{78} See note 46 supra.
\textsuperscript{79} 368 U.S. 337, 344 (1961). \textit{Cf.} Howard v. Commissioner, 24 T.C. 792, 804 (1955), \textit{rev'd on other grounds}, 238 F.2d 943 (7th Cir. 1956) (construction of "solely" comparable to that urged by Hartford stockholders might satisfy practical objectives of statute but authorities require the contrary).
\textsuperscript{80} 24 T.C. 792 (1955), \textit{rev'd on other grounds}, 238 F.2d 943 (7th Cir. 1956).
\textsuperscript{81} 79.82\% of the Binkley stock was acquired from stockholders who received only Truax-Traer stock, 19\% from stockholders who received only cash, and the balance from Parsons College, which received both cash and Truax-Traer stock. The total amount of Binkley stock acquired for Truax-Traer stock was 80.19\%. 24 T.C. at 800.
The main opinion's dismissal in Reeves of what Judge Wilbur regarded as a "formidable body of directly contrary precedents"\textsuperscript{83} formed the gravamen of his dissent in that case. One can disagree with his rigid view of the function of \textit{stare decisis},\textsuperscript{84} but his trenchant criticism of the methodology used in the main opinion is difficult to quarrel with. The taxpayers did concede integration of the cash purchases and the exchange for purposes of their argument that "solely" requires that only eighty percent control be acquired for voting stock. The concession was essential to an articulate statement of the issue. Yet the main opinion avoided the issue by assuming the purchases were separate and only then passing on the content of "solely."\textsuperscript{85} The more ingenuous approach of the Pierson trial court and the concurring opinion in Reeves is preferable and certainly more workable, for it obviates resolution of the separability question.

The trial courts' approach in both Reeves and Pierson is amply supported by present policy considerations. Hartford remained intact as an operating insurance company and the owners of eighty-seven percent\textsuperscript{86} of its stock continued as stockholders of ITT. Only two prior stock-for-stock exchanges foundering on the "solely" issue involved such a high degree of continuity, and they can be explained on other grounds.\textsuperscript{87} The only conceivable objection to deferral of the tax consequences of the Hartford-ITT exchange lies in a statutory relic whose purpose has not been allowed to illuminate its meaning. The Reeves and Pierson trial courts imparted an understanding of "solely" which better comports both with that purpose and with the reality of how

\begin{itemize}
\item \textsuperscript{83} 71 T.C. at 744 (Wilbur, J., dissenting).
\item \textsuperscript{84} Judge Wilbur's attack on dismissing what he regarded as indistinguishable precedent probably was shared by those in agreement with the main opinion; only two of the eleven judges who considered the case agreed with the concurring opinion's position that Howard should be overruled. 71 T.C. at 752. This is not the first example of the Tax Court refusing to overrule old but questionable precedent. See, e.g., Hirst v. Commissioner, 63 T.C. 307 (1974), aff'd, 572 F.2d 427 (4th Cir. 1978); Cowles v. Commissioner, 29 T.C.M. (CCH) 884 (1970). But see Alex v. Commissioner, 70 T.C. 322 (1978).
\item \textsuperscript{85} See text accompanying note 26 \textit{supra}. This criticism seems particularly apt in the context of a motion for summary judgment, which requires that there be no genuine issue of material fact. See \textit{TAX CT. R. PRAC. \\& PROC.} 121.
\item \textsuperscript{86} See note 21 \textit{supra}.
\item \textsuperscript{87} Lutkins v. United States, 312 F.2d 803 (Ct. Cl.), \textit{cert. denied}, 375 U.S. 825 (1963), was a creeping acquisition occurring over a forty year period. The law then in effect did not permit creeping B reorganizations, even in the absence of boot. See note 46 \textit{supra}. Mills v. Commissioner, 39 T.C. 393 (1962), \textit{rev'd on other grounds}, 331 F.2d 321 (5th Cir. 1964), involved the payment of cash in lieu of fractional shares of stock in the acquiring corporation. The Tax Court's finding that the exchange was not solely for voting stock was reversed on the ground that the cash did not represent consideration for stock in the acquired corporation.
\end{itemize}
Moreover, that understanding is one which prevents recognition of loss by sprinkling a small amount of cash on an otherwise perfect B reorganization—a result unobtainable in other types of nontaxable exchanges.

Recommendations

The ultimate disposition of these cases, especially Pierson, will help clarify the meaning of "solely," but confusion over the contours of a B reorganization will persist regardless of their outcome. Both opinions declined consideration of the effect of their holdings on creeping reorganizations. Furthermore, Reeves gave virtually no guidance as to when an exchange constitutes a single transaction independent of previous cash purchases. Thus, the lower court decisions were so narrow that any number of variations of the facts in future transactions could have rendered them distinguishable. True, availability of an advance ruling on the consequences of a proposed transaction diminishes risk, but a threshold of certainty should exist apart from the Internal Revenue Service's ruling position. Want of a threshold improperly substitutes the Service's judgment for that of Congress and the courts and may hold proposed transactions entirely deserving of tax-free treatment hostage to a practically unreviewable body of "law." The Service would not have ruled favorably on the Hartford-ITT exchange if ITT had not purged itself of the previously purchased stock, yet the Reeves and Pierson trial courts said the transaction would have been tax-free anyway. Furthermore, the Service deserves more specific guidance for ruling on proposed transactions. What is needed is a more definitive legislative statement of the conformation of a B reorganiza-


89. See I.R.C. §§ 351(b)(2), 356(c), 1031(c). See also Turnbow v. Commissioner, 368 U.S. 337 (1961), in which the stock acquisition was 70% for cash and 30% for stock; the court there established that § 356 cannot apply to a stock-for-stock exchange and denied B reorganization status by reason of the transfer of boot.


91. The main opinion tersely admonishes against splitting an otherwise single transaction into a sale and exchange. Reeves v. Commissioner, 71 T.C. 727, 742 n.19 (1979). On appeal, however, the case was remanded to the trial court for further consideration on the issue of the scope of the plan of reorganization. Chapman v. Commissioner, 80 U.S. Tax Cas. ¶ 9330 (1st Cir. 1980).
tion, taking into account the doctrinal concepts the government and taxpayers might invoke to support a desired result.

Proposals for major overhaul of the reorganization provisions have come and gone since 1954.92 The following ideas are intended once again to provoke thought on a better formula for a B reorganization, but with an awareness that changes in the makeup of a B reorganization should be part of a larger effort (not developed here) to unify the treatment of various forms of acquisitive reorganizations.93

As a starting point, "solely" should be deleted from section 368(a)(1)(B). In its place should be substituted a required percentage of continuity of ownership. To achieve B reorganization status, stock in the acquiring corporation must comprise at least that percentage of the total consideration received by stockholders of the acquired corporation. Eighty percent, the quantum prescribed in section 368(c), would be an acceptable figure; other proposals have suggested fifty percent and sixty-six and two-thirds percent.94 Selecting the appropriate figure, however, can wait; recognizing the need for an arbitrary limit will suffice here. Whatever the figure, it could be applied either on an aggregate or individual stockholder basis. The former approach would determine the existence of a B reorganization by reference to the total consideration transferred by the acquiring corporation, without regard to the mix of consideration received by any particular stockholder. A reorganization for one would be a reorganization for all. The alterna-


93. See ADVISORY GROUP REPORT, supra note 92, at 75-77; ALI Study, supra note 92, at 20.

94. ADVISORY GROUP REPORT, supra note 92, at 76; ALI Study, supra note 92, at 29.
tive is to treat only those stockholders whose consideration consists of the required percentage of stock in the acquiring corporation as having participated in a reorganization. The aggregate approach is preferable for its simplicity if nothing else.\textsuperscript{95} Depending on the terms of the offer and the response to it, the ultimate mix of consideration a particular stockholder will receive may be unknown when the consequences of a proposed transaction must be represented to the stockholders. Telling stockholders that the transaction will be tax-free to some, but not to others, adds incremental confusion for dubious benefit. Furthermore, an individual stockholder approach would mark a radical departure from the present treatment of a reorganization as a unitary concept.

A separate but related aspect of the required level of continuity concerns the degree of control of the target company which the acquiring company must possess. This figure need not necessarily be the same as the percentage of consideration which the acquiring corporation's stock must comprise. One proposal mirrors section 368(c) and calls for eighty percent control by the acquiring company while requiring only sixty-six and two-thirds percent of the consideration to be stock in the acquiring corporation.\textsuperscript{96} In view of the policy of tax deferral only to stockholders of the acquired corporation where their investment does not undergo a significant change, the eighty percent requirement should not be reduced. Regardless of the mix of consideration stockholders of the acquired corporation receive, it is difficult to say their interests have changed only in form, or that the business enterprise has continued, where the acquiring corporation does not possess that degree of control which for various purposes the Code treats as a rough equivalent of identity.\textsuperscript{97}

If some amount of boot is permitted in B reorganizations, it should be taxed in the same manner as in other acquisitive reorganizations. Section 356 taxes the receipt of boot either as gain (usually capital gain) or as a dividend (if it has that effect), but only to the extent of the amount of gain inherent in the disposed stock. The provision has been criticized, justifiably, for thus limiting the taxable portion of what in effect are often dividends.\textsuperscript{98}

The treatment of creeping B reorganizations needs considerable

\textsuperscript{95} The \textit{ALI Study}, supra note 92, at 29, adopts an aggregate approach. \textit{Contra}, Advisory Group Report, supra note 92, at 78.

\textsuperscript{96} Advisory Group Report, supra note 92, at 76.

\textsuperscript{97} See generally I.R.C. \S\S 332, 351, 1504.

\textsuperscript{98} Advisory Group Report, supra note 92, at 66-67; \textit{ALI Study}, supra note 91, at 29.
clarification. Before 1954 they were not permitted.\textsuperscript{99} Committee reports on the 1954 amendments evince a clear intent to allow creeping stock acquisitions but do not state a policy for the change.\textsuperscript{100} Presumably, the policy was to facilitate simplification of corporate structure through a tax-free exchange of stock in a parent corporation for stock in a partially owned subsidiary.\textsuperscript{101} Yet this notion was not limited to situations in which the parent wants to eliminate an outstanding minority interest. For example, the Senate report sanctioned the acquisition of sixty percent of the stock in a subsidiary in which the acquiring corporation had purchased a thirty percent interest sixteen years before.\textsuperscript{102}

Granting reorganization status to an exchange that results in the acquiring corporation either acquiring or increasing its control may undermine continuity-of-interest principles. For example, if Corporation $A$ already owns sixty percent of the stock in Corporation $B$ and acquires the remaining forty percent in exchange for its stock, the adequacy of continuity depends on when and how the sixty percent was acquired. If the acquisition were a sufficiently long time ago, continuity is acceptable regardless of how the block was acquired, because at the time of the exchange Corporation $A$ has supplanted the previous owners of the sixty-percent block. If, however, the block were acquired shortly before the exchange, the degree of continuity depends on the form of consideration paid by Corporation $A$ to acquire the block. If the consideration is stock, continuity arguably is one hundred percent, but if cash were used continuity would be only forty percent because insufficient time has lapsed to regard Corporation $A$ as having supplanted the previous owners.

Such difficulties are thought to be resolved by the step transaction doctrine; the purchase is ignored if, in the vernacular, it is "old and cold." The step transaction approach is unpredictable, being greatly dependent on how the arbiter of fact divines subjective intent. It should give way to objective temporal criteria,\textsuperscript{103} which could serve two important functions: one, to establish a time frame in which the acquiring corporation must obtain control, and in which stock exchanges must occur to be part of the reorganization and hence tax-free; and two,

\textsuperscript{99} See notes 46, 62 supra.


\textsuperscript{101} See Advisory Group Report, supra note 92, at 78.

\textsuperscript{102} This example became part of Treas. Reg. §§ 1.368-2(c) (1955).

\textsuperscript{103} Treas. Reg. §§ 1.368-2(c) (1955) uses 12 months as a cutoff for stock exchanges included within the "acquisition" for purposes of I.R.C. § 368(a)(1)(B). In American Potash & Chemical Corp. v. United States, 402 F.2d 1000 (Ct. Cl. 1968), the government argued that 12 months was merely a guidelines. For discussion, see note 36 supra.
to mark a point before which cash purchases would be ignored for purposes of determining whether the required percentage of consideration paid by the acquiring corporation consisted of its stock. The required periods should be determinable by reference to an easily identifiable event, such as the adoption of a formal statement or plan. In light of the reality of hostile takeovers, execution of the document by the acquired corporation should not be mandatory. The acquired corporation is not an indispensable party; the exchange between its stockholders and the acquiring corporation can proceed with or without the acquired corporation’s blessing.

An objective approach to the contours of a creeping reorganization can accommodate a reasonable compromise between policy and pragmatism and can do so with greater certainty than the present formula provides. If adopted, the objective rules should preempt to the greatest extent possible application of doctrinal concepts such as continuity-of-interest and step transactions.

Current reorganization definitions do not place limits on the relative size of the acquiring and acquired corporations. Whales can swallow minnows and vice versa. Continuity-of-interest is diluted to some extent in any acquisitive reorganization; the “mere change in form” rubric is never absolutely true. The business of the acquired corporation is blended with that of the acquiring corporation and control over the business is henceforth shared. Where the imbalance disproportionately favors the acquiring corporation, as where a large conglomerate takes over a small company, the dilution can be so extreme as to call the basic policy of tax deferral into question. Exchanging control of a small company for an infinitesimal share of a company whose stock is publicly traded is little different from selling out for cash. Deferral of tax until the stock is sold, regardless of its liquidity, is acceptable, but in the interim one must strain to find continuity in any but a highly technical sense. In addition to questions of tax policy, tax-free treatment of such an acquisition also conflicts with some current views of desirable antitrust policy. Some limit probably should be placed on the relative size of companies participating in reorganizations, with adequate safeguards to prevent circumvention of the limit through reversing the identity of the acquiring and acquired corporations. Such a provision, however, would disqualify small companies as tax-free takeover candidates in most situations, depriving their owners of the opportunity to “sell out” on a tax-free basis. Why they should be

105. See ALI Study, supra note 91, at 24, 28.
treated differently from a multitude of stockholders of a larger acquired company whose individual continuity of control over their investments following a merger may be far less is a legitimate inquiry, one which goes to the treatment of a reorganization as a unitary concept.

Perhaps, then, Congress should consider radical surgery on the reorganization provisions, treating each stockholder's exchange on an individual basis. If such a system looked not only to the type of consideration received, however, but also to individual continuity of control (as opposed to continuity of mere ownership), it would make a tax-free exchange the exclusive right of substantial stockholders in relatively large target companies, for only they would have sufficient ownership in a merged entity to claim anything close to ongoing control. Refinements obviously could be devised to alleviate concerns of this nature, but is not the more basic question, to which this discussion seems inexorably headed, exactly why reorganizations should be tax-free in the first place? Continuity-of-interest is a multi-faceted, elusive concept, which in the context of reorganizations seems harder to grasp the more one analyzes it. Yet it looms as the major justification of the reorganization provisions. These final thoughts are not intended to close in confusion, but rather to illustrate the need for a statute with a more articulate link to its underlying policy.

106. See text accompanying note 95 supra.