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B Reorganizations: The Voting Stock Rule Revisited

B REORGANIZATIONS: THE VOTING STOCK RULE REVISITED

The Internal Revenue Code of 1954 (I.R.C.) imposes a tax on all gains from the sale or exchange of property unless otherwise provided.[1] Conversely, certain losses incurred from the disposition of property are deductible from gross income.[2] The corporate reorganization provisions,[3] however, provide important exceptions to these general rules.[4] The reorganization provisions authorize individual and corporate taxpayers to defer the recognition of specified gains and losses and to treat qualified reorganizations as nontaxable events.[5] The I.R.C. defines six categories of corporate acquisitions which qualify as "reorganizations" for purposes of nonrecognition.[6] An extremely popular category is the stock-for-stock, or "B reorganization," which allows the shareholders of an acquired corporation to exchange their shares for voting stock in the acquiring corporation without current tax significance.[7]

The I.R.C. contains three principal provisions governing B reorganizations.[8] Section 354 provides that no gains or losses shall be recognized when, pursuant to a plan of reorganization, shareholders exchange their stock or securities solely for stock or securities in the same corporation

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[1] I.R.C. § 61(a)(3) (gains derived from dealings in property includible in gross income); *id.* § 1001 (amount of gain or loss is difference between amount realized for property and adjusted basis; gains must be recognized unless otherwise provided).

[2] *Id.* § 165(a) (losses sustained during taxable year are deductible, if taxpayer is not compensated by insurance or otherwise).

[3] *Id.* §§ 354-68.

[4] For a general discussion of the corporate reorganization provisions, *see* Freling & Martin, *Current Reorganization Techniques*, 55 TAXES 852 (1977); Krane, *Current Problems in Acquisitive Reorganizations*, 51 TAXES 737 (1973); Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183 (1957) [hereinafter cited as Darrell].

[5] I.R.C. § 354(a).

[6] *Id.* § 368(a)(1). The six categories of corporate reorganizations recognized by § 368 are statutory mergers or consolidations, stock-for-stock acquisitions, asset reorganizations, asset transfers under §§ 354, 355 and 356, recapitalizations, and changes in identity, form or place. *See* note 4 *supra*.

[7] I.R.C. § 368(a)(1)(B). The term "B reorganization" and similar designations for other corporate reorganizations are derived from the subsection codification. Thus, an asset reorganization under § 368(a)(1)(C) is commonly called a "C reorganization."

The six statutory forms of reorganization accommodate a variety of non-tax business objectives and plans. *See* Darrell, *supra* note 4, at 1183-84; note 6 *supra*. An A, B, or C reorganization is employed when the reorganization plan contemplates a permanent combination of the operations or assets of two or more corporations. A B reorganization is utilized when the acquiring corporation seeks to acquire a subsidiary and to preserve the subsidiary as a separate corporate entity. *See generally* Stark, *Non-Income Tax Aspects of Corporate Reorganizations: A Check List of the Issues and Problems*, 24 N.Y.U. INST. ON FED. TAX 1085 (1966); Darrell, *supra* note 4.

[8] *See* I.R.C. §§ 354(a)(1), 358(a)(1), 368(a)(1)(B).

or another corporation party to the reorganization.[9] Section 358 provides, in turn, that the shareholders' basis in the voting stock received shall be the same as the basis of shares transferred, minus any "boot"[10] received in the exchange.[11] Thus, shareholders defer recognition of appreciation or depreciation by retaining the original basis of shares in the acquired corporation. Gain will be recognized to the full extent of the exchange, however, if the transaction is not pursuant to a plan of reorganization, or not qualified as a reorganization under the tax laws.[12]

Section 368(a)(1)(B) defines B reorganization as the acquisition by one corporation, solely in exchange for its voting stock, of shares in another corporation, if immediately following the acquisition the acquiring corporation has control.[13] Section 368(c) defines "control" as ownership of at

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[9] *Id.* § 354(a)(1). An exchange of stock normally would involve gains or losses based upon the relative value of shares, or the enhancement of ownership interest through acquisition of voting rights. Section 354(a)(1) serves to defer recognition in conjunction with a qualified reorganization. *Cf. id.* § 361(a) (nonrecognition of gain or loss to corporation involved in reorganization); *id.* § 1031(a) (nonrecognition of gain or loss on exchange of productive property held for trade, business or investment). Section 354(a)(1) does not, however, purport to define qualified reorganizations. *See* note 6 *supra.*

[10] "Boot" refers to any additional (nonstock) consideration received by the shareholders in the course of the reorganization. The Internal Revenue Service defines additional consideration as other property received by shareholders in addition to property permitted to be received without recognition of gain. Treas. Reg. § 1.356-1(a) (1960).

[11] I.R.C. § 358(a)(1). *See generally id.* § 1012 (general rule defining basis in property); *id.* § 1011(a) (defining adjusted basis for determining gain or loss); *id.* § 362(b) (governing basis of shares received by acquiring corporation). Section 358(a)(1) provides that the basis of voting stock received must be reduced by any gain recognized to the shareholders. Such adjustments in the substituted basis, however, usually are not applicable to stock-for-stock exchanges, since § 368(a)(1)(B) generally precludes nonstock consideration in a B reorganization. *See* note 13 *infra.*

[12] I.R.C. § 354(a)(1). Nonrecognition is an all-or-nothing proposition for shareholders in a B reorganization. Section 356 provides generally that if a shareholder receives nonstock consideration in the course of a qualified reorganization, gain must be recognized only to the extent attributable to the boot. *Id.* § 356(a)(1). Section 368(a)(1)(B) usually precludes all forms of boot in a B reorganization, however, and renders § 356(a)(1) inapplicable to stock-for-stock exchanges. *See* note 13 *infra.* Thus, the presence of boot in a B reorganization disqualifies the entire transaction from nonrecognition. Turnbow v. Commissioner, 368 U.S. 337, 343 (1961); Lutkins v. United States, 312 F.2d 803, 806 (Ct. Cl.), *cert. denied,* 375 U.S. 825 (1963). *But see* Vernava, *The* Howard *and* Turnbow *Cases and the "Solely" Requirement for B Reorganizations,* 20 TAX L. REV. 387, 399, 401 (1965) [hereinafter cited as Vernava] (arguing for recognition only to extent of boot). The harsh result of full recognition is a peculiarity of B reorganizations. In contrast, participants in a C reorganization can receive up to 20% nonstock consideration, and recognize gain only to the extent of boot. I.R.C. §§ 356(a)(1), 368(a)(2)(B). Statutory mergers and consolidations under § 368(a)(1)(A) can include substantial cash or other consideration, so long as the transaction is not a sale. *See* Roebling v. Commissioner, 143 F.2d 810 (3d Cir.), *cert. denied,* 323 U.S. 773 (1944) (continuity of interest requirement in statutory mergers); Treas. Reg. § 1.368-2(a)-(b) (1976). Thus, A and C reorganizations accord greater flexibility in planning, and much less risk of disqualification. *See also* I.R.C. § 351 (property transferred to corporation in exchange for stock and boot taxable only to extent of boot.)

[13] I.R.C. § 368(a)(1)(B). This section defines a B reorganization as

the acquisition by one corporation, in exchange solely for all or a part of its voting least eighty percent of the total combined voting power of all classes of stock entitled to vote, and at least eighty percent of all other classes of stock.[14] Section 368(a)(1)(B) authorizes step-by-step, or "creeping acquisitions," if the series of transactions is pursuant to a plan of reorganization and the acquisition is completed within a reasonable time.[15] To qualify for nonrecognition, therefore, a taxpayer must demonstrate that he and other shareholders transferred their shares "solely for voting stock," and that immediately afterwards the acquiring corporation possessed the requisite eighty percent ownership in the acquired corporation.

Congress enacted the B reorganization provisions in the Internal Revenue Act of 1934.[16] The primary purposes of this legislation were to

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> 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);

Id. Section 368(a)(1)(B) contemplates that shareholders of the acquired corporation exchange their shares "solely for voting stock" in the acquiring corporation or its controlling parent. The courts and the Internal Revenue Service have construed the term "voting stock" on a case-by-case basis. *See* Forest Hotel Corp. v. Fly, 112 F. Supp. 782, 789 (S.D. Miss. 1953) (common stock precluded from voting because of arrearages on preferred stock is voting stock; preferred stock voting because of arrearages is also voting stock); Firestone Tire & Rubber Co., 2 T.C. 827, 829 (1943) (treasury stock can be voting stock); Rev. Rul. 339, 1966-2 C.B. 274 (voting agreements, warrants, options, convertible debentures not "voting securities").

[14] I.R.C. § 368(c). The control requirement for B reorganizations may be difficult to achieve. The 80% requirement for "other classes of stock" is not cumulative, but requires 80% control of each class of nonvoting stock. Rev. Rul. 259, 1959-2 C.B. 115. Section 368(a)(1)(B) expressly states that the acquiring corporation must possess control immediately after the exchange, whether or not a shift of control results from the reorganization. When the acquiring corporation has insufficient voting stock to acquire the requisite shares, the plan may require a reverse acquisition and later recapitalization. *See* Dailey, *The Voting Stock Requirement of B and C Reorganizations*, 26 TAX L. REV. 725, 734 (1971) [hereinafter cited as Dailey]. Furthermore, the I.R.C. does not define the concepts of "total combined voting power" and "stock entitled to vote." The term "stock entitled to vote" probably excludes stock with minimal voting rights under local law. In addition, "stock entitled to vote" probably does not include stock with contingent voting rights, at least until the contingency has occurred. *See* Treas. Reg. § 1.302-3(a)(3) (1960) (stock with contingent voting rights not "voting stock" until specified event occurs); Rev. Rul. 339, 1966-2 C.B. 274 (voting agreements, warrants, options, convertible debentures not "voting securities").

[15] *See* S. REP. NO. 1622, 83d Cong., 2d Sess. 273, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4911 (discussing allowance for step-by-step reorganizations). According to the I.R.S., a creeping acquisition must be completed within a relatively short period of time, such as twelve months. Treas. Reg. § 1.368-2(c) (1960).

[16] Int. Rev. Code of 1934, ch. 277, § 112(g)(1), 48 Stat. 680 (now I.R.C. § 368(a)(1)). The history of the B reorganization provisions is well documented in congressional reports and interpretive case law. The Internal Revenue Code of 1924 defined "reorganization" as a "merger or consolidation" including acquisition by one corporation of a majority of voting stock and other classes of stock in another corporation. Int. Rev. Code of 1924, ch. 234, § 203(h)(1), 43 Stat. 253 (now I.R.C. § 368(a)(1)). The 1924 I.R.C. authorized nonrecognition whether or not boot was exchanged in gaining control. *Id.* To distinguish tax-free reorganizations from sales, the courts developed the "continuity of interest" doctrine which required

encourage efficient corporate organization and to facilitate restructuring in the interest of competition.[17] These provisions, however, had an additional objective. Congress was aware that taxable corporate sales were cast frequently in the form of corporate reorganizations to avoid

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the exchange of some quantum of stock in addition to purchase money. *E.g.*, Pinellas Ice Co. v. Commissioner, 287 U.S. 462, 470 (1933); Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933). The continuity of interest doctrine has continued to evolve under a succession of amendments to the Internal Revenue Code. LeTulle v. Scofield, 308 U.S. 415 (1940); G & K Mfg. Co. v. Helvering, 296 U.S. 389 (1935); Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); Treas. Reg. §§ 1.368-1(b), 1.368-2(a) (1960). As developed by the courts, continuity of interest requires both a substantial continuity in proprietary interest, and a substantial participation by shareholders of the acquired corporation. *See* Commissioner v. Berghash, 361 F.2d 257, 259-60 (2d Cir. 1966) (50% reduction in participation by shareholders terminates continuity of interest); note 72 *infra*.

Widespread tax avoidance under the 1924 provision resulted in amendment under the Internal Revenue Code of 1934. *See* Int. Rev. Code of 1934, ch. 277, § 112(g)(1), 48 Stat. 680 (now I.R.C. § 368(a)(1)). The report of the House Ways and Means Committee observed that the 1924 Act permitted reorganizations to take a wide variety of forms without income tax liability. H. REP. NO. 704, 73d Cong., 2d Sess. 13 (1934) [hereinafter cited as H.R. REP. NO. 704]. As a result, astute lawyers took advantage of the reorganization provisions by arranging corporate sales in the technical form of tax-free reorganizations. *Id. See also* S. REP. NO. 558, 73d Cong., 2d Sess. 15 (1934) [hereinafter cited as S. REP. NO. 558]. The 1934 revision therefore provided that the acquiring corporation must acquire, solely in exchange for its voting stock, at least 80% of the acquired corporation's voting shares and other classes of stock, or substantially all the property of the acquired corporation. Int. Rev. Code of 1934, ch. 277, § 112(g)(1), 48 Stat. 680 (now I.R.C. §§ 368(a)(1)(B)-(C)). With these revisions, Congress intended to eliminate tax avoidance in conjunction with corporate sales, and to continue the policy of encouraging stock-for-stock and asset reorganizations. H.R. REP. NO. 704, *supra*, at 14. The 80% control requirement and the "solely for voting stock" rule were thus designed to restrict nonrecognition to a limited number of reorganizations by emphasizing the substance of the transaction rather than the form.

Congress amended the reorganization provisions again in 1939, to clarify the status of assumed liabilities and to nullify the Supreme Court's decision in United States v. Hendler, 303 U.S. 564 (1938). *Hendler* held, *inter alia*, that the assumption of liabilities by an acquiring corporation was equivalent to an exchange of boot, and would disqualify an otherwise tax-free reorganization. *Id.* at 567. To overcome this obstacle, Congress separated the treatment of stock and asset reorganizations and expressly forgave the assumption of liabilities in asset reorganizations. *See* Int. Rev. Code of 1939, ch. 247, § 213, 53 Stat. 863 (now I.R.C. §§ 368(a)(1)(B)-(C)).

The 1954 Code further refined the reorganization provisions. To allow step-by-step or creeping acquisitions, Congress abandoned the single-transaction requirement for B reorganizations. S. REP. NO. 1622, 83d Cong., 2d Sess. 273, *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4911 [hereinafter cited as S. REP. NO. 1622]. *See* I.R.C. § 368(a)(1)(B); Treas. Reg. § 1.368-2(c) (1960). In addition, Congress amended the provision governing asset, or C reorganizations, to allow up to 20% boot including liabilities assumed. I.R.C. §§ 368(a)(1)(C), 368(a)(2)(B). Congressional policy toward nonstock consideration in B reorganizations conformed to prior law, but remained somewhat ambiguous. *See* S. REP. NO. 1622 at 273, [1954] U.S. CODE CONG. & AD. NEWS at 4682.

[17] Mills v. Commissioner, 331 F.2d 321, 323 (5th Cir. 1964); *see* H.R. REP. NO. 704, *supra* note 16, at 14. The role of the reorganization provisions in encouraging corporate mergers may conflict in some instances with the antitrust laws. *See* note 37 *infra*.

recognition of gains.[18] Thus, Congress enacted the "solely for voting stock" language and the eighty percent control requirement to limit nonrecognition to bona fide reorganizations.[19] These restrictions circumscribed the availability of stock-for-stock acquisitions, and set limits on the general policy favoring reorganizations.[20] Construction of the "solely for voting stock" rule is therefore critical to the balance that Congress intended to achieve between the encouragement of reorganizations and the prevention of tax avoidance.[21]

The courts traditionally have given strict construction to the "solely for voting stock" requirement in section 368(a)(1)(B).[22] As developed by the courts, the doctrine of strict construction has precluded the transfer of any nonstock consideration in qualified stock-for-stock exchanges.[23] Recently, the First and Third Circuits reaffirmed strict construction of the voting stock rule and overturned lower court decisions challenging the vitality of this judicial doctrine.[24] In *Chapman v. Commissioner*[25] and *Heverly v. Commissioner*,[26] the First and Third Circuits held that acquisition of stock by an acquiring corporation must be exclusively in ex-

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[18] S. REP. NO. 558, *supra* note 16, at 15; H.R. REP. NO. 704, *supra* note 16, at 13.

[19] H.R. REP. NO. 704, *supra* note 16, at 14.

[20] *Id.*

[21] *See* Comment, *The "Solely for Voting Stock" Requirement of B Reorganizations:* Reeves *v.* Commissioner, 79 COLUM. L. REV. 774, 793-96 (1979) (discussing balance of conflicting purposes in § 368(a)(1)(B)) [hereinafter cited as *Voting Stock Requirement*].

[22] Howard v. Commissioner, 24 T.C. 792, 806 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956); *see* Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 198 (1942) (strict construction of statute governing B and C reorganizations); Swanson v. United States, 479 F.2d 539, 545 (9th Cir. 1973) (requirements for reorganization are detailed and precise, and must be specifically met); Simon v. United States, 402 F.2d 272, 279 (Ct. Cl. 1968) (all criteria for § 368 reorganization must be met).

[23] 24 T.C. at 806. The traditional construction of the "solely for voting stock" rule focuses on the consideration paid by the acquiring corporation for the shareholders' stock. The payment of nonstock consideration directly or indirectly in exchange for stock in the acquired corporation renders the reorganization a taxable event. *Id.* Transfers made to the acquired corporation or its shareholders, however, in exchange for debt instruments or assets of the acquired corporation, may not violate the voting stock rule. *See* Rev. Rul. 269, 1970-1 C.B. 82 (exchange of stock options severable from B reorganization); Rev. Rul. 91, 1969-1 C.B. 106 (exchange of debentures involving few shareholders severable from stock-for-stock exchange). Furthermore, a transfer in respect of treasury stock, while indirectly benefiting shareholders of the acquired corporation, does not result in disqualification. Rev. Rul. 522, 1972-2 C.B. 215.

[24] Chapman v. Commissioner, 618 F.2d 856, 862 (1st Cir. 1980), *vacating*, Reeves v. Commissioner, 71 T.C. 727 (1979); Heverly v. Commissioner, 621 F.2d 1227, 1246 (3d Cir. 1980), *rev'g*, Reeves v. Commissioner, 71 T.C. 727 (1979); Pierson v. Commissioner, 472 F. Supp. 957 (D. Del. 1979). The appeal in *Chapman* and the consolidated appeals in *Heverly* arose from a common factual situation. *See* text accompanying notes 34-37 *infra*. For discussion of the *Reeves* decision, *see* Thurmond & Horvitz, *Nonstock Consideration in a "B" Reorganization: the* Reeves *Case*, 11 TAX ADVISOR 232 (1980) [hereinafter cited as Thurmond & Horvitz]; *Voting Stock Requirement*, *supra* note 21.

[25] 618 F.2d 856 (1st Cir. 1980).

[26] 621 F.2d 1227 (3d Cir. 1980).

change for voting stock if shareholders of the acquired corporation are to defer recognition of gains.[27] The courts further held that the requirements for a B reorganization are not met where an acquisition includes nonstock consideration, even though over eighty percent of the stock is exchanged for voting stock in the acquiring corporation.[28] In so ruling, the courts reaffirmed strict construction of the "solely for voting stock" requirement and conformed to the long-standing Supreme Court decision in *Helvering v. Southwest Consolidated Corporation.*[29]

The *Chapman* and *Heverly* decisions are significant because they reestablish the conventional strict construction of the B reorganization provisions. The influence of these decisions, however, is somewhat uncertain. For many years, the federal courts have engrafted *de minimus* exceptions to the "solely for voting stock" rule, reflecting both the exigencies of the commercial world[30] and judicial discomfort with the statutory requirements.[31] The Internal Revenue Service (I.R.S.) also has adopted a nontechnical construction on a case-by-case basis.[32] The B reorganization provisions have therefore remained a source of uncertainty in the tax law, despite successive reenactments by Congress and repeated judicial construction.[33]

The *Chapman* and *Heverly* cases arose from a common set of facts involving acquisition of the Hartford Fire Insurance Company (Hartford)

[27] 618 F.2d at 856; 621 F.2d at 1228. The *Chapman* and *Heverly* courts, respectively, vacated and reversed decisions by the lower courts authorizing nonrecognition in stock-for-stock exchanges involving up to 20% boot. 618 F.2d at 877; 621 F.2d at 1246. The circuit courts remanded the cases for consideration of an argument not on appeal. *See* note 40 *infra.*

[28] 618 F.2d at 856; 621 F.2d at 1228.

[29] 315 U.S. 194, 198 (1942). *Southwest Consolidated* was an asset reorganization case arising under § 112(a)(1)(B) of the 1934 Revenue Act. 315 U.S. at 195. The same provisions of the 1934 Act governed stock-for-stock and asset reorganizations. *See* note 16 *supra.* Confronted with the "solely for voting stock" language, the Court ruled that "solely" leaves no leeway, and that voting stock plus some other consideration does not meet the statutory requirement. 315 U.S. at 198. Despite the separation of asset and stock-for-stock reorganizations under the 1939 Revenue Act, the I.R.S. and the courts have continued to apply strict construction to the B reorganization provisions. *E.g.*, Turnbow v. Commissioner, 368 U.S. 337, 341 (1961); Howard v. Commissioner, 24 T.C. 792, 806 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956); Rev. Rul. 123, 1975-1 C.B. 115.

[30] *See* Mills v. Commissioner, 331 F.2d 321, 324-25 (5th Cir. 1964). *Mills* held that cash payments for fractional shares did not disqualify an otherwise valid B reorganization. *Id.* The court reasoned that the payment of boot for fractional shares was an administrative convenience, and did not constitute an independent part of the consideration. The court declined to decide whether a *de minimus* ruling otherwise would have been warranted. *Id.* at 325. *See* text accompanying notes 100-106 *infra.*

[31] *See* Heverly v. Commissioner, 621 F.2d 1227, 1243, 1245 (3d Cir. 1980) (desirability of voting stock rule unclear).

[32] *E.g.*, Rev. Rul. 365, 1976-2 C.B. 1101; Rev. Rul. 54, 1973-1 C.B. 187 (payment of reorganization expenses by acquiring corporation); Rev. Rul. 562, 1968-2 C.B. 157 (permitting majority shareholder in acquiring corporation to purchase 50% of target corporation two months prior to reorganization). *See* text accompanying notes 100-106 *infra.*

[33] *See* note 16 *supra.*

by International Telephone and Telegraph (ITT).[34] Appellees were among 17,000 shareholders of Hartford who exchanged their shares for voting stock in ITT, pursuant to an offer by ITT in May of 1970. ITT first proposed merger in October, 1968. The Hartford management rejected this proposal, however, and in November ITT began purchasing Hartford shares on the open market. By March of 1969, ITT had secured nearly eight percent of Hartford's single class of stock.[35] Negotiations between the companies continued throughout 1969, and a final plan of reorganization was presented to Hartford shareholders on May 23, 1970. The shareholders overwhelmingly approved the proposal, relying in part upon a private letter ruling by the I.R.S. granting conditional approval of the plan.[36] The merger resulted in the exchange of more than ninety-five percent of Hartford stock for ITT's cumulative convertible voting preferred stock.

In March, 1974, the I.R.S. retroactively revoked approval of the reorganization and assessed deficiencies.[37] Various shareholders contested the revocation, as reported in *Reeves v. Commissioner*[38] and *Pierson v. Commissioner.*[39] The petitioners presented two arguments. First, the shareholders argued that the cash purchases by ITT were severable from the subsequent stock-for-stock exchange, and that the exchange of shares was therefore "solely for voting stock."[40] Second, the petitioners

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[34] 618 F.2d at 857; 621 F.2d at 1228. The Commissioner has two other appeals pending on the same facts as *Chapman* and *Heverly.* Reeves v. Commissioner, No. 79-1438 (4th Cir., argued Feb. 6, 1980); Coffen v. Commissioner, *appeal docketed,* No. 79-7278 (9th Cir. June 18, 1979).

[35] 618 F.2d at 858; 621 F.2d at 1228.

[36] 618 F.2d at 858; 621 F.2d at 1228-29. The Commissioner approved the tax-exempt status of the ITT-Hartford reorganization in April, 1969, upon condition that ITT dispose of its 8% interest in the Hartford. Pursuant to the letter ruling, ITT sold the Hartford shares to an Italian bank prior to the stock-for-stock exchange. 618 F.2d at 858; 621 F.2d at 1228-29; *cf.* Rev. Rul. 354, 1972-2 C.B. 216 (approving similar divestiture in B reorganization). *See generally* Rev. Proc. 22, 1980-26 I.R.B. 26 (June 30, 1980) (guidelines and procedures for advance rulings).

[37] 618 F.2d at 858; 621 F.2d at 1229. The I.R.S. cited misrepresentations concerning ITT's sale of stock to the Italian bank because of the latter's participation in the subsequent stock-for-stock exchange. 618 F.2d at 859; 621 F.2d at 1229. For purposes of appeal, the parties in *Chapman* stipulated that ITT's cash purchases would be treated as part of the overall acquisition effort. *See* note 40 *infra.*

The ITT-Hartford reorganization was also challenged by the Department of Justice for violation of the Clayton Act, 15 U.S.C. §§ 12-27 (1976). United States v. I.T.T. Corp., [1971] Trade Cas. (CCH) ¶ 73,666 (D. Conn. Sept. 24, 1971). In a negotiated settlement, ITT retained Hartford subject to the divestiture of several smaller subsidiaries and certain restrictions on future acquisitions in the insurance industry.

[38] Reeves v. Commissioner, 71 T.C. 727 (1979), *vacated sub nom.* Chapman v. Commissioner, 618 F.2d 856 (1st Cir. 1980), *rev'd sub nom.* Heverly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980).

[39] Pierson v. Commissioner, 472 F. Supp. 957 (D. Del. 1979), *rev'd sub nom.* Heverly v. Commissioner, 621 F.2d 1227 (3d Cir. 1980).

[40] 71 T.C. at 731; 472 F. Supp. at 960. The *Reeves* and *Pierson* courts never reached the shareholders' argument that ITT's cash purchases were severable from the stock-for-

argued that even if the cash purchases were part of the same acquisition, the fact that over eighty percent of Hartford shares were exchanged "solely for voting stock" satisfied the requirements of section 368(a)(1)(B).[41] The lower courts granted summary judgment on the basis of petitioners' second argument.[42] Both courts held that where a single stock-for-stock exchange results in more than eighty percent acquisition, the requirements of section 368(a)(1)(B) are satisfied, regardless of boot.[43]

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stock exchange. For purposes of appeal, the taxpayers in *Chapman* stipulated that the ITT purchases were part of the overall reorganization effort. Chapman v. Commissioner, 618 F.2d 856, 859 (1st Cir. 1980). In *Heverly*, the shareholders continued to assert on appeal that the cash purchases were severable from the plan of reorganization. Heverly v. Commissioner, 621 F.2d 1227, 1246 (3d Cir. 1980). These shareholders also argued that even if the purchases were part of the reorganization plan, they were separate "transactions" and severable from the "acquisition" under § 368. *Id.* at 1231 n.3; *see Voting Stock Requirement, supra* note 21, at 800-02 ("acquisition" under § 368 includes stock and boot "transactions"). Both circuit courts remanded the cases for further consideration of the severability issue. 618 F.2d at 877; 621 F.2d at 1246.

The argument that ITT's purchases are severable from the plan of reorganization derives from express language in § 368 and certain principles underlying the step-transaction doctrine. Section 368 provides that acquisitions of stock must be in pursuance of a reorganization plan to qualify for nonrecognition. I.R.C. § 368(a)(1)(B). *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 (1959). The courts have applied principles from the step-transaction doctrine to determine which events in a series of transactions are pursuant to a plan of reorganization. In general, transactions in excess of 12 months duration have been held ineligible for qualification, unless the transactions are part of a continuing offer by the acquiring corporation. American Potash & Chemical Corp. v. United States, 402 F.2d 1000, 1001 (Ct. Cl. 1968); Lutkins v. United States, 312 F.2d 803, 804-05 (Ct. Cl.), *cert. denied*, 375 U.S. 825 (1963). Thus, transactions occurring beyond the 12 month limit usually cannot be included in determining whether requirements have been met. 402 F.2d at 1001. *See* Treas. Reg. § 1.368-2(c) (1960) (B reorganizations must be complete within relatively short time, such as 12 months).

The facts in *Chapman* and *Heverly* provide some support for the shareholders' severability argument. ITT's cash purchases of stock preceded agreement with Hartford concerning the reorganization. 618 F.2d at 858; 621 F.2d at 1228. ITT first initiated the cash purchases of stock after the Hartford management rejected a merger proposal by ITT. 618 F.2d at 857; 621 F.2d at 1228. Furthermore, the series of transactions which led to the stock-for-stock exchange extended over a period of 14 months, two months beyond the period the I.R.S. will look for qualified transactions. *See* text accompanying notes 34-36 *supra*.

[41] 71 T.C. at 731-32; 472 F. Supp. at 961. Petitioners construed § 368(a)(1)(B) to require that stock in the acquired corporation be exchanged "solely for voting stock" to the extent necessary to acquire "control" (80%). 71 T.C. at 731-32; 472 F. Supp. at 961. The shareholders argued that "solely for voting stock" refers specifically to the acquisition of control and not to the plan of reorganization as a whole. 71 T.C. at 731-32; 472 F. Supp. at 960-61. Under the shareholders' view, acquisition of 80% control through a stock-for-stock exchange ensures that the acquisition is not a corporate sale, and that the continuity of interest requirement is substantially fulfilled. *See* note 16 *supra*. The same argument was raised and rejected in Howard v. Commissioner, 24 T.C. 792, 803 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956). *See generally* Vernava, *supra* note 12, at 399 (discussing relationship between control requirement and voting stock rule).

[42] Pierson v. Commissioner, 472 F. Supp. 957, 975 (D. Del. 1979); Reeves v. Commissioner, 71 T.C. 727, 742 (1979).

[43] 71 T.C. at 741; 472 F. Supp. at 975. The reasoning in *Pierson* is instructive. The *Pier-*

The First and Third Circuits rejected the lower courts' construction of the statute and remanded the cases for further consideration.[44] The First Circuit, in *Chapman*, found the presence of boot totally inconsistent with tax deferral, whether or not such purchases were necessary to acquire control.[45] The court then held that in order to qualify for nonrecognition of gain, a transfer of stock in a B reorganization must be exclusively in exchange for voting stock.[46]

The *Chapman* court's reasoning is not complex. The court conceded that the language of section 368(a)(1)(B) lends itself to several interpretations.[47] Relying on precedent, however, the court ruled that *Southwest Consolidated* and the Tax Court's decision in *Howard v. Commissioner*[48] compel adherence to strict construction of the "solely for voting stock" rule.[49] The *Howard* decision was the linchpin of the *Chapman* court's analysis.[50] In *Howard*, the Tax Court held that an acquiring corporation's

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son court distinguished Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942), by arguing that because *Southwest Consolidated* involved an asset reorganization, the case was inapposite to interpretation of § 368(a)(1)(B). 472 F. Supp. at 974. The court further suggested that the 1954 amendments to § 368(a)(1)(C) superceded the *Southwest Consolidated* decision, and reflected congressional discontent with strict construction of the "solely for voting stock" rule. *Id.* at 974-75; *see* note 16 *supra*. The *Pierson* court reasoned that since Congress permitted up to 20% boot in asset reorganizations, an equivalent amount should be permissible in B reorganizations absent a clear rule to the contrary. 472 F. Supp. at 973; *see* note 12 *supra*. The *Pierson* court inferred an 80% rule for B reorganizations from the statutory history governing C reorganizations. *See* note 16 *supra*. The *Pierson* reasoning, and similar logic in *Reeves*, has been criticized heavily by some commentators. *See* Thurmond & Horvitz, *supra* note 24, at 240; *Voting Stock Requirement*, *supra* note 21, at 797-98.

[44] Chapman v. Commissioner, 618 F.2d 856, 877 (1st Cir. 1980); Heverly v. Commissioner, 621 F.2d 1227, 1246 (3d Cir. 1980). Both the *Chapman* and *Heverly* courts remanded for consideration of the severability issue. *See* note 40 *supra*.

[45] 618 F.2d at 862.

[46] *Id.* at 856.

[47] *Id.* at 863. The *Chapman* court recognized two possible constructions of § 368(a)(1)(B), including the Tax Court's construction in Reeves v. Commissioner, 71 T.C. 727 (1979). *Reeves* held that a qualified reorganization occurs whenever the acquiring corporation exchanges sufficient voting stock to attain 80% control, even if the acquiring corporation purchases other stock for cash. 71 T.C. at 741. The second possible construction is the "prescriptive" or strict construction, which interprets "solely for voting stock" to mean that a B reorganization must be entirely free of nonstock consideration. According to the *Chapman* court, neither construction is compelled by the language of § 368(a)(1)(B). 618 F.2d at 863.

[48] Howard v. Commissioner, 24 T.C. 792 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956).

[49] 618 F.2d at 872.

[50] *See id.* at 869. *Howard* involved a B reorganization under § 112(g)(1)(B) of the 1939 Act (now I.R.C. § 368(a)(1)(B)). 24 T.C. at 792; *see* note 16 *supra*. The Truax-Traer Coal Company entered into an agreement to acquire the Binkley Coal Company and Binkley's subsidiary, Pyramid Coal. The plan of reorganization included a direct stock-for-stock exchange of unissued Truax-Traer voting stock for 80.19% of Binkley's outstanding shares. 24 T.C. at 800. Truax-Traer purchased the remaining Binkley shares for cash, with one Binkley shareholder receiving both stock and boot. *Id.* The issue in *Howard* was whether the "solely for voting stock" language in § 112(g)(1)(B) referred to the entire reorganization, or only to the 80% control requirement. 24 T.C. at 803.

Except for dictum in Commissioner v. Air Reduction Co., 130 F.2d 145, 148 (2d Cir.), cash purchases of stock preclude qualification as a B reorganization, even though over eighty percent of the acquired corporation's shares are exchanged solely for voting stock.[51] The *Howard* court further held that achievement of control through a bona fide stock-for-stock exchange is not alone sufficient to fulfill the purposes of the reorganization provisions.[52]

The First Circuit found *Howard* indistinguishable from *Chapman* and dispositive of the issue on appeal.[53] The lower court in *Reeves* had distinguished *Howard* based on the receipt of "mixed consideration" by a shareholder in the acquired corporation,[54] and on the ground that *Howard* involved a single transaction rather than several stages.[55] The First Circuit found, however, that mixed consideration was irrelevant to the outcome in *Howard*,[56] and that severability was inapposite to the *Chapman* appeal.[57]

The First Circuit also rejected the lower court's emphasis on the

cert. denied, 317 U.S. 681 (1942), *Howard* was the only decision prior to *Chapman* and *Heverly* to confront the relationship of the 80% control requirement to the "solely for voting stock" rule. *See* Vernava, *supra* note 12, at 388 (discussing issue addressed in *Howard*).

[51] 24 T.C. at 792. The Seventh Circuit affirmed the Tax Court's construction of the "solely for voting stock" rule, reversing on other grounds. Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956). The Seventh Circuit relied on a 1934 Report of the Senate Finance Committee and the Supreme Court's decision in Helvering v. Southwest Consolidated, 315 U.S. 194 (1942), to affirm strict construction of the voting stock rule despite separate treatment accorded stock and asset reorganizations under the 1939 Act. 238 F.2d at 946; *see* S. REP. No. 558, *supra* note 16, at 16-17; note 16 *supra*.

[52] 24 T.C. at 804. In *Howard*, the former shareholders of the acquired corporation had reported long-term capital gains on subsequent sales of stock in the acquiring corporation, predicated on a substituted basis and lengthened holding period. *Id.* at 800-01; *see* I.R.C. § 1223 (rules governing holding period for property received in exchange). The shareholders argued that the 80.19% exchange of stock and recognition of long-term gains substantially fulfilled the purposes of the reorganization provisions. *Id.* at 804. In opposition, the I.R.S. argued that the shareholders should have recognized gain on the reorganization exchange, and reported short-term gain on the subsequent sales of stock. *Id.* at 801.

[53] 618 F.2d at 871.

[54] Reeves v. Commissioner, 71 T.C. 727, 737 (1979). One shareholder in *Howard* received both voting stock and boot in exchange for his shares in the acquired corporation. Howard v. Commissioner, 24 T.C. 792, 800 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956); *see* note 50 *supra*. The *Reeves* court reasoned that the acquiring corporation in *Howard* had failed to attain 80% control of the acquired corporation "solely for voting stock" because "mixed consideration" had tainted the stock-for-stock exchange. 71 T.C. at 737. In contrast, the *Reeves* court found that Hartford shareholders in the exchange with ITT had received either voting stock or cash, but not both. *Id.* at 741-42.

[55] 71 T.C. at 736.

[56] 618 F.2d at 872. The *Howard* Court made no finding of fact regarding mixed consideration and based its holding on entirely different grounds. *See* 24 T.C. at 792; text accompanying notes 51-52 *supra*.

[57] 618 F.2d at 872. The distinction between single step and creeping acquisitions was largely eliminated by the 1954 amendments to § 368(a)(1)(B). *See* note 16 *supra*. The distinction, if relevant at all, relates to the issue of severability which the *Reeves* court failed to address. *See* note 40 *supra*.

passage of control, finding such emphasis inimical to the 1954 amendments.[58] The Tax Court in *Reeves* had ruled that the transfer of eighty percent control in one transaction satisfied the purposes of section 368(a)(1)(B), and distinguished the ITT reorganization from earlier case law.[59] The First Circuit found, however, that emphasis on acquiring an eighty percent block of shares frustrates the intent of Congress to treat step-by-step acquisitions the same as other B reorganizations.[60] The court reasoned that the transfer of control is irrelevant under the present statute, so long as the acquiring corporation possesses control upon completing the reorganization.[61] The First Circuit held, therefore, that a single, eighty percent exchange of stock does not relieve the shareholders from the requirements of the voting stock rule.[62]

Finally, the First Circuit criticized the *Reeves* court's statutory construction and understanding of the legislative history. The *Reeves* opinion suggested that the relaxation of requirements for asset reorganizations in the 1954 amendments should apply to B reorganizations.[63] The First Circuit, however, viewed the 1954 amendments as an effort by Congress to treat each form of reorganization separately, and to grant leeway only as Congress directed.[64] Similarly, the circuit court considered the allowance for "creeping acquisitions" to be a matter of legislative grace, not intended to weaken the "solely for voting stock" rule.[65]

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[58] 618 F.2d at 864-65.

[59] Reeves v. Commissioner, 71 T.C. 727, 741 (1979).

[60] 618 F.2d at 864. The *Reeves* decision may be criticized for attempting to create a special exception to the step-transaction doctrine whenever 80% control passes in a single stock-for-stock exchange. The step-transaction doctrine requires that a series of events be treated as a single transaction and accorded uniform tax significance whenever a common purpose or design links the events. *See generally* Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX 247 (1954). Congress intended that the step-transaction doctrine apply to corporate reorganizations, especially with regard to creeping acquisitions. S. REP. NO. 1622, *supra* note 16, at 273, [1954] U.S. CODE CONG. & AD. NEWS at 4911; *see* Rev. Rul. 16, 1973-1 C.B. 186 (applying step-transaction doctrine to D reorganization under 1939 Act). The Tax Court in *Reeves*, however, seemingly has recognized an exception by according separate tax significance to ITT's stock and cash acquisitions. *See Voting Stock Requirement, supra* note 21, at 800 (discussing application of step-transaction doctrine to "acquisitions" under § 368(a)(1)(B)).

[61] 618 F.2d at 864. The last phrase of § 368(a)(1)(B) expressly precludes any requirement for passage of control. *See* note 13 *supra*. Thus, the Tax Court's emphasis on the transfer of control is irrelevant to qualification under the statute, and is not a valid method of distinguishing the ITT case from earlier precedent.

[62] 618 F.2d at 864.

[63] Reeves v. Commissioner, 71 T.C. 727, 738-39 (1979). C reorganizations can include up to 20% boot, including liabilities assumed. I.R.C. §§ 368(a)(1)(B), 368(a)(2)(B); *see* note 16 *supra*.

[64] 618 F.2d at 876; *see* note 16 *supra*.

[65] *Id.; cf.* Commissioner v. Air Reduction Co., 130 F.2d 145 (2d Cir.), *cert. denied*, 317 U.S. 681 (1942). *Air Reduction* involved a step-by-step or creeping acquisition under § 112(g)(1)(B) of the 1934 Act. *See* note 16 *supra*. The acquiring corporation achieved 82.9% control through successive stock-for-stock exchanges, and purchased the remaining shares

The Third Circuit's opinion in *Heverly v. Commissioner*[66] is in general accord with the *Chapman* holding. First, the *Heverly* court rejected the implication in *Reeves* and *Pierson* that the settled construction of section 368(a)(1)(B) is irrational.[67] Second, the court found that the construction of the "solely for voting stock" rule in *Southwest Consolidated* applies to B reorganizations.[68] Third, the *Heverly* court found error in the lower courts' interpretation of congressional intent, and inferences drawn from adjacent provisions governing C reorganizations.[69] The Third Circuit reasoned that Congress has recognized important differences between stock-for-stock exchanges and other forms of reorganization, and has intentionally created independent statutory requirements for each form.[70] Thus, the court found that successive reenactments of clause B have indicated a congressional intent to retain the traditional construction of the "solely for voting stock" rule.[71]

In addition, the *Heverly* court found error in associating the "continuity of interest" doctrine[72] with the "control" requirement in section 368(a)(1)(B).[73] Both the *Reeves* and *Pierson* courts had found that eighty percent control satisfies the requirement for continuity of interest in a B

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for cash. 130 F.2d at 146. The court applied the strict construction doctrine of Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942), and held that the acquisition was disqualified under § 112. 130 F.2d at 148. Unlike the court in *Chapman*, however, the Second Circuit in *Air Reduction* found that the acquiring corporation had been dealing in its own stock, and had employed treasury shares as an ordinary asset in a variety of transactions. 130 F.2d at 148.

[66] 621 F.2d 1227 (3d Cir. 1980).

[67] *Id.* at 1232.

[68] *Id.* at 1234. The *Reeves* court distinguished *Southwest Consolidated* as an asset reorganization case. 71 T.C. at 736-37. The *Pierson* court distinguished *Southwest Consolidated* on similar grounds, emphasizing the separate treatment accorded stock and asset acquisitions under the present statute. 472 F. Supp. at 969, 974-75; *see* note 16 *supra*. On appeal, the shareholders argued that *Southwest Consolidated* involved 37% nonstock consideration, far more than the 8% involved in the ITT-Hartford acquisition. 621 F.2d at 1234.

[69] 621 F.2d at 1243-45. The Third Circuit rejected inferences drawn from the treatment of statutory mergers and consolidations under § 368(a)(1)(A). *Id.*; *see* Roebling v. Commissioner, 143 F.2d 810, 814 (3d Cir.), *cert. denied*, 323 U.S. 773 (1944) (continuity of interest requirement for statutory mergers).

[70] 621 F.2d at 1243-45.

[71] *Id.*; *Voting Stock Requirement*, *supra* note 21, at 799. *But see* Commissioner v. Air Reduction Co., 130 F.2d 145, 147 (2d Cir.), *cert. denied*, 317 U.S. 681 (1942) (successive reenactment of reorganization provisions not adoption of administrative interpretation).

[72] The "continuity of interest" doctrine is of judicial origin, and requires that the shareholders of the acquired corporation retain a continuing interest in the reorganized corporation. *See* note 16 *supra*. Factors to be considered include continuity of the business enterprise, shareholder control in the reorganized corporation, duration of continuing interests, participation in earnings, and ownership of assets. Since the courts require a substantial proprietary interest, the exchange of short term notes or similar obligations generally is insufficient. Treas. Reg. § 1.368-1(b) (1960); *cf.* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468-69 (1933) (promissory notes not "securities" under reorganization provisions).

[73] 621 F.2d at 1241.

reorganization.[74] The Third Circuit distinguished these elements as conceptually independent, however, and ruled that continuity of interest relates to the entire consideration of the exchange.[75] The court reasoned that the control requirement of section 368 and the continuity of interest doctrine serve divergent congressional policies and require independent satisfaction.[76]

In sum, the *Chapman* and *Heverly* decisions reflect a cautious reading of the legislative history, deference to precedent, and adherence to the traditional construction of the voting stock rule. The circuit courts found that strict construction supports congressional policy and promotes stability and certainty in the tax laws.[77] Both courts rejected attempts by the lower courts to create a special exception to the step-transaction doctrine[78] and to depart from established case law.[79]

Despite the reasoning in the *Chapman* and *Heverly* decisions, strict construction of the "solely for voting stock" rule poses at least three problems for businessmen, attorneys, and the courts. First, the reestablishment of strict construction in *Chapman* and *Heverly* fails to ensure stability and certainty in the administration of the tax laws. The judicial doctrine of strict construction has not prevented inconsistent application of the "solely for voting stock" rule.[80] The I.R.S. and the courts frequently have adopted a case-by-case approach to B reorganizations and have discarded strict construction in a variety of fact situations.[81] As in many situations in which an exception has been made, the transfer of boot in *Chapman* and *Heverly* was minor compared to the overall consideration.[82] The voting stock rule, therefore, remains a source of con-

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[74] *See* text accompanying note 41 *supra*.

[75] 621 F.2d at 1241-43.

[76] *Id.* at 1243. The Third Circuit found that Congress intended the control requirement to insure a substantial change in corporate form, while the "solely for voting stock" rule was designed to insure continuity of interest. *Id.* The court further found that modification of corporate form is an independent requirement of the reorganization provisions. *Id.*; *cf.* Scofield v. San Antonio Transit Co., 219 F.2d 149, 154 (5th Cir. 1954), *cert. denied*, 350 U.S. 823 (1955) (C reorganization provisions contemplate modification in corporate form). Thus, the court rejected the shareholders' argument that the voting stock rule relates to the control requirement, and held that both the voting stock and control requirements must be independently satisfied. *Id.* at 1243, *see* Howard v. Commissioner, 24 T.C. 792, 804-06 (1955), *rev'd on other grounds*, 238 F.2d 943 (7th Cir. 1956) (rejecting relationship between voting stock and control requirements); Swanson v. United States, 479 F.2d 539, 545 (9th Cir. 1973) (requirements for § 368 reorganization are detailed and precise, and must be met specifically); Simon v. United States, 402 F.2d 272, 279 (Ct. Cl. 1968) (all criteria for § 368 reorganization must be met).

[77] 618 F.2d at 874; 621 F.2d at 1232.

[78] 618 F.2d at 869; 621 F.2d at 1229, 1245-46; *see* note 60 *supra*.

[79] *See* notes 49 & 68 *supra*. *But see* Helvering v. Hallock, 309 U.S. 106, 119-20 (1940) (discussing limits of *stare decisis* in construction of tax legislation).

[80] *See* text accompanying notes 30-31 *supra*.

[81] *See* text accompanying notes 100-106 *infra*.

[82] 618 F.2d at 858; 621 F.2d at 1228. The nonstock consideration in *Chapman* and *Heverly* constituted less than 8% of the total value exchanged. 618 F.2d at 858; 621 F.2d at

siderable uncertainty in corporate tax planning.

A second problem which arises from the *Chapman* and *Heverly* decisions is that strict construction only partially fulfills the purposes of the reorganization provisions. Section 368(a)(1)(B) serves two disparate objectives in corporate tax policy.[83] The primary function of the reorganization provisions is to encourage reorganization and to strengthen corporate structures by eliminating negative tax consequences.[84] Congress added the voting stock rule in 1934 to prevent shareholders from disguising corporate sales as bona fide reorganizations and avoiding otherwise taxable gains.[85] At the same time, Congress unintentionally facilitated the recognition of losses by strictly circumscribing the conditions for nonrecognition.[86] After 1934, the statute struck an uneasy balance between conflicting policies and rendered administration of the tax laws exceedingly complex.[87]

Rather than reflecting Congress' intended balance between encouraging reorganizations and limiting tax avoidance, strict construction of the voting stock rule serves almost exclusively to eliminate the avoidance of gains.[88] The general policy favoring corporate reorganizations, while not wholly frustrated, is subordinate to the dictates of an inflexible judicial doctrine. The strictures placed on B reorganizations render qualification exceedingly difficult, particularly where the corporate parties are large and complex, or the shareholders have divergent interests.[89] Furthermore, strict construction affords taxpayers a ready

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1228. Furthermore, ITT had divested itself of all shares purchased with cash prior to the stock-for-stock exchange. 618 F.2d at 858; 621 F.2d at 1229; *see* note 36 *supra*.

[83] *See* text accompanying notes 17-20 *supra*.

[84] Mills v. Commissioner, 331 F.2d 321, 323 (5th Cir. 1964); *see* text accompanying note 17 *supra*.

[85] S. REP. NO. 558, *supra* note 16, at 15; H.R. REP. NO. 704, *supra* note 16, at 13.

[86] *See* Dranginis, *Tax Planning*, 3 CORP. L. REV. 123, 124 (1980) (discussing intentional transfer of boot to insure recognition of losses). Section 356(c) prohibits recognition of loss by shareholders who receive both property and boot pursuant to a plan of reorganization. Participants in a B reorganization, however, can insert small amounts of boot in an otherwise qualified exchange and disqualify the entire reorganization. *See* note 12 *supra*. Thus, taxpayers can manipulate the requirements of § 368(a)(1)(B) to facilitate the recognition of losses. This "loophole" in § 356(c) derives from the strict qualification requirements of § 368(a)(1)(B), and is founded on the same construction which precludes limited recognition of gains. *See generally Voting Stock Requirement*, *supra* note 21, at 793-96 (discussing § 356(c)); note 12 *supra*.

[87] Turnbow v. Commissioner, 286 F.2d 669, 674-75 (9th Cir. 1960), *rev'd on other grounds*, 368 U.S. 337 (1961); *see* text accompanying notes 17-20 *supra*.

[88] The 80% requirement arguably is sufficient to preclude nonrecognition in corporate sales, to fulfill the requirement for change in corporate form, and to insure substantial continuity of interest. *See* Heverly v. Commissioner, 621 F.2d at 1243 (statutory requirements higher than necessary to serve congressional policies). One commentator has suggested that recognition of gain in circumstances involving less than 20% boot results in unjustifiable hardship for shareholders who continue to risk substantial portions of their capital. Vernava, *supra* note 12, at 399.

[89] *See* text accompanying notes 100-106 *infra*.

formula for tax avoidance whenever loss recognition is desired. Contrary to the intent of Congress, taxpayers can include small amounts of boot in a stock-for-stock acquisition and ensure recognition of losses in an otherwise qualified exchange.[90]

The statutory language does not compel such anomalous results.[91] The Congress has not articulated a preference for strict construction of the voting stock rule.[92] The decisions in *Chapman* and *Heverly* espouse a long-standing judicial preference for strict construction in order to promote stability and certainty in the tax laws.[93] A more balanced and flexible construction, however, would better serve the goals of Congress.[94]

A final problem resulting from the *Chapman* and *Heverly* decisions is that strict construction presents practical dilemmas for working attorneys and reduces certainty in reorganization plans. Acquisitions rarely, if ever, involve a simple stock-for-stock exchange absent other contractual settlements or inducements. Reorganization plans include the distribution or liquidation of assets, continuation of employee contracts or benefits, renewal of leases for equipment or land, payments to nonassenting shareholders, and other ancillary matters.[95] Where the acquired corporation is closely-held, the beneficiaries of such agreements are frequently shareholders prohibited from receiving boot.[96]

Strictly construed, the "solely for voting stock" requirement does not easily accommodate commercial imperatives such as asset liquidations, contract extensions, and shareholder payoffs.[97] The sweeping prohibition

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[90] *See* note 86 *supra*.

[91] 618 F.2d at 863; 621 F.2d at 1240, 1245-46; *see* I.R.C. § 368(a)(1)(B).

[92] 618 F.2d at 876. The 1954 report of the Senate Finance Committee contains language which seems to authorize the receipt of boot by shareholders in all corporate reorganizations. *See* note 16 *supra*. Nevertheless, the *Chapman* court found that the legislative history of the reorganization provisions contains no clear guidance for construction of the voting stock rule. 618 F.2d at 876. Cognizant that § 368(a)(1)(B) may be an "overreaction" to the problem of corporate sales, the court laid responsibility for reform on the Congress. 618 F.2d at 876.

[93] 618 F.2d at 876; 621 F.2d at 1232.

[94] *See* note 16 *supra*.

[95] *See* Dailey, *supra* note 14, at 776 (discussing reorganization complexities and side transactions).

[96] *See* Stockton Harbor Indus. Co. v. Commissioner, 216 F.2d 638, 645 (9th Cir.), *cert. denied*, 349 U.S. 904 (1954) (discussing loan to shareholder of closely-held farm). The status of side transactions is rendered even more uncertain when obligations are later terminated by payment rather than by performance. Uncertainty is increased, for example, when shareholders of the acquired corporation bargain for lengthy employment contracts. If the contracts are terminated at a later date, the I.R.S. can characterize the settlement as boot. Under such circumstances, qualification under § 368(a)(1)(B) may be uncertain for years.

In Commissioner v. Gordon, 391 U.S. 83 (1968), the Supreme Court stated that the essential character of a transaction should not depend upon uncertain future events. *Id.* at 96. According to the Court, Code provisions must conform to the basic premise of annual tax accounting and should not remain indeterminable and unfixed for indefinite periods. *Id.* The strict requirements of § 368(a)(1)(B), however, often preclude such certainty.

[97] *See* Dailey, *supra* note 14, at 776 (discussing § 368(a)(1)(B) and side transactions).

of *Southwest Consolidated* is often too inflexible to meet the complex requirements of reorganization.[98] The courts and the I.R.S., therefore, have recognized a variety of practical exceptions to the voting stock rule.[99] The acquiring corporation may purchase unissued shares from the acquired corporation for boot,[100] and may pay the reorganization expenses of the acquired corporation.[101] Fractional shares may be purchased for cash where the shareholder's interest is not divisible by the value of voting stock exchanged.[102] Nonassenting bondholders may be paid off in cash or assets of the acquired corporation.[103] The acquired corporation may distribute excess assets to shareholders in the form of a redemption.[104] A majority shareholder in the acquiring corporation may pur-

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[98] *See* Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 198 (1942); note 29 *supra*.

[99] *See* Reeves v. Commissioner, 71 T.C. 727, 740 (1979) (discussing exceptions to voting stock rule).

[100] Rev. Rul. 522, 1972-2 C.B. 215. *See also* Roosevelt Hotel Co., 13 T.C. 399, 408-09 (1949) (purchase of unissued shares in C reorganization).

[101] Rev. Rul. 54, 1973-1 C.B. 187.

[102] Mills v. Commissioner, 331 F.2d 321, 324-25 (5th Cir. 1964); Rev. Rul. 114, 1971-1 C.B. 133; Rev. Rul. 365, 1966-2 C.B. 116. The *Mills* court held that the payment of cash for fractional shares was an administrative adjustment and justified by principles of accounting. 331 F.2d at 323; *see* note 30 *supra*.

[103] Rev. Rul. 285, 1968-1 C.B. 147; *see* Southland Ice Co., 5 T.C. 842, 850 (1945). *Southland Ice* involved an asset reorganization under § 112(g)(1)(B) of the 1934 Act and subsequent amendments. *See* note 16 *supra*. The acquired corporation was in receivership, and the bondholders' committee adopted a reorganization plan subject to the committee's acquisition of corporate property at the foreclosure sale. 5 T.C. at 844. As the transaction developed, almost 94% of the bondholders in the acquired corporation participated in the reorganization, and received 100% of the income bonds issued by the successor corporation. 5 T.C. at 847. Nonassenting bondholders were paid off in cash by the receiver out of income accumulated during the receivership and prior to creation of the successor corporation. *Id.* The Tax Court held that the reorganization qualified for nonrecognition notwithstanding that a small minority of nonassenting bondholders were paid in cash out of funds retained by the receiver. *Id.* at 842. The court distinguished Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942), by holding that the funds retained and used to pay off the bondholders were not additional consideration. 5 T.C. at 850.

Most state corporation laws provide a procedure for eliminating dissident shareholders by calling-in or redemption. *See, e.g.*, A.B.A.-A.L.I. MODEL BUS. CORP. ACT §§ 68, 80 (1979); Rev. Rul. 345, 1956-2 C.B. 206. Prohibiting this procedure under § 368(a)(1)(B) makes little sense, since under the proper circumstances both pre- and post-reorganization redemptions are authorized by state law. *See* Daisy M. Ward, 29 B.T.A. 1251, 1254 (1934) (redemption two days after reorganization severable from stock-for-stock exchange); Vernava, *supra* note 12, at 298. *See also* I.R.C. §§ 371, 372 (reorganization in receivership and bankruptcy proceedings; payoffs to bondholders and other creditors).

[104] Commissioner v. Gordon, 391 U.S. 83 (1968); American Potash & Chemical Corp. v. United States, 402 F.2d 1000 (Ct. Cl. 1968). I.R.C. § 355 governs the distribution of corporate stocks and securities during reorganization and may be used to distribute unneeded assets. *See* Massee, *Section 355: Disposal of Unwanted Assets in Connection With a Reorganization*, 22 TAX L. REV. 439 (1967) (discussing nonrecognition in simultaneous divisive and unifying reorganizations); Piper, *Combining a Spin-off With a Merger—Recent Developments*, 49 TAXES 134 (1971) (discussing risks in combining corporate division and merger).

chase substantial amounts of stock in the acquired corporation for cash.[105] Furthermore, the acquiring corporation may loan cash to a shareholder in the acquired corporation and incorporate the loan into the reorganization plan.[106]

The *Chapman* court dismissed the relevance of these exceptions, labeling them "minor deviations."[107] Nevertheless, the established exceptions to strict construction and related unresolved issues challenge the vitality of the voting stock rule. In many instances, ancillary agreements are important inducements to reorganization and contribute a significant element to the overall consideration.[108] So long as the language of

[105] Rev. Rul. 562, 1968-2 C.B. 157. Revenue Ruling 562 demonstrates the inconsistency with which the I.R.S. has applied the reorganization provisions. An individual owned 90% of the acquiring corporation and only two months prior to reorganization purchased 50% of the "target" corporation's outstanding shares. The Commissioner found that the individual was acting "for his own account" and held that the subsequent reorganization qualified under § 368(a)(1)(B). 1968-2 C.B. at 158.

[106] Stockton Harbor Indus. Co. v. Commissioner, 216 F.2d 638, 645 (9th Cir.), *cert. denied*, 349 U.S. 904 (1954). In *Stockton Harbor*, the acquired corporation was a closely-held farm reorganizing under § 112(g)(1)(B) of the 1939 Act. 216 F.2d at 638, 645. In the course of the reorganization effort, a director of the acquiring corporation agreed to lend the principal shareholder of the acquired corporation $20,000, to be secured by voting stock which the shareholder was about to receive. *Id.* at 642. The plan of reorganization included this "side transaction," and the monies lent passed through escrow in conjunction with the acquisition. *Id.* at 641, 645.

[107] Chapman v. Commissioner, 618 F.2d 856, 876 n.41 (1st Cir. 1980). The government conceded that an "overly technical" construction of the "solely for voting stock" rule fails to support congressional policy. Reeves v. Commissioner, 71 T.C. at 740; *see* text accompanying notes 83-90 *supra*. One commentator has distinguished the exceptions to strict construction by arguing that § 368(a)(1)(B) focuses on consideration paid by the acquiring corporation, and not consideration received by the shareholders. *Voting Stock Requirement, supra* note 21, at 786. Thus, distributions of property and cash prior to reorganization are allowable because the transaction does not involve a transfer from the acquiring corporation. *E.g.*, Commissioner v. Gordon, 391 U.S. 83, 96 (1968) (distribution of assets by acquired corporation prior to reorganization); Southland Ice Co., 5 T.C. 842, 851 (1945) (payment by receiver of acquired corporation to nonassenting bondholders prior to reorganization).

The focus on transfers by the acquiring corporation, however, exhalts form over substance. Section 354 governs the nonrecognition of gains and losses of shareholders. The technical source of the boot is irrelevant if the distribution is in respect of stock and related to the overall reorganization plan. *See* Rev. Rul. 360, 1975-2 C.B. 110 (pre-reorganization redemption by acquired corporation constitutes additional consideration in stock-for-stock exchange). A distribution by the acquired corporation prior to reorganization depletes the assets of the corporation and affects the value of shares to be exchanged. The shareholders are compensated for the diminished value of their shares by participation in the distribution and investment in the reorganized corporation. A pre-reorganization distribution is therefore equivalent to a transfer of boot for shareholders who participate in both the distribution and the subsequent stock-for-stock exchange. The emphasis on consideration paid by the acquiring corporation also fails to explain many of the established exceptions to the voting stock rule. *See, e.g.*, notes 105-106 *supra*.

[108] *See* Dailey, *supra* note 14, at 776. Dailey argues that contract inducements should not be characterized as boot, if commercially justified and not simply designed to benefit shareholders in the acquired corporation. Dailey also would allow side transactions proposed as conditions precedent to reorganization. *Id.*

section 368(a)(1)(B) is strictly construed, such agreements will require special determination by the Commissioner or the courts.[109]

The decisions in *Chapman v. Commissioner* and *Heverly v. Commissioner* reaffirm the long-standing construction of section 368(a)(1)(B) and represent a sound interpretation of leading precedents. Strict construction of the "solely for voting stock" requirement, however, underscores conflicting policies contained in the present statutory scheme, and exacerbates problems associated with qualification as a B reorganization. Although the present interpretation is largely a creature of judicial construction, the courts have chosen not to deviate from precedent.[110] Absent judicial or congressional action, however, certainty in the law regarding B reorganizations will remain a distant goal.

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[109] As *Reeves* and *Pierson* suggest, a more flexible construction of § 368(a)(1)(B) would reduce uncertainty by accommodating limited nonstock consideration in side transactions, and would facilitate the elimination of nonassenting shareholders and the assumption of corporate liabilities. Allowance of up to 20% boot would provide planners a margin of error without jeopardizing congressional policies. *See* Vernava, *supra* note 12, at 399.

[110] *See* Helvering v. Hallock, 209 U.S. 106, 119-20 (1940) (absence of congressional repudiation does not preclude courts from reconsidering judicial construction of tax legislation, when construction conflicts with intrinsically sounder doctrine).