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## REORGANIZATION OF SAVINGS AND LOAN ASSOCIATIONS UNDER SECTION 368—A RETURN TO THE “CONTINUITY OF INTEREST” TEST

Section 61 of the Internal Revenue Code generally provides for the inclusion of all gains from the disposition of property in a taxpayer's gross income.<sup>1</sup> However, recognizing the burden placed on a taxpayer whose gain takes the form of a mere “paper profit,”<sup>2</sup> the Code states that not all gains which are realized by the taxpayer<sup>3</sup> are recognized.<sup>4</sup> Section 1002 of the Code requires that the gain or loss realized on the sale or exchange of property be recognized, except where otherwise specifically provided in the Internal Revenue Code.<sup>5</sup> One such exception is specified in § 361.<sup>6</sup> This section provides for the nonrecognition

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<sup>1</sup>INT. REV. CODE OF 1954, § 61. Taxable income is defined as gross income “minus the deductions allowed by this chapter,” in the case where an individual elects not to take the standard deduction. INT. REV. CODE OF 1954, § 63(a). Where, however, the individual elects to use the standard deduction under § 144, his taxable income means “adjusted gross income minus—(1) such standard deduction, and (2) the deductions for personal exemptions provided in section 151.” *Id.*, § 63(b). Deductions allowed in the computation of taxable income under § 63(a) include, among others, interest paid on indebtedness, § 163(a); various state and local taxes paid, § 164(a); losses sustained and not compensated for by insurance, § 165(a); and depreciation, § 167(a). For purposes of § 63 gross income “means all income from whatever source derived, including . . . Gains derived from dealings in property.” *Id.*, § 61(a)(3).

<sup>2</sup>A “paper profit” is a transaction in which the taxpayer's investment merely changes form. An example of such a transaction is found in the situation where the shareholder receives a certificate or other document evidencing his interest in the surviving corporation in exchange for the document evidencing his interest in the acquired corporation. Although he may have realized a profit, it is only on paper, and there has been merely a change in the form in which the shareholder's investment is held, without any passing of money, and therefore, any profit the shareholder may realize on such a transfer is termed a “paper profit.” See S. REP. NO. 617, 65th Cong., 3d Sess. 5-6 (1918); H.R. REP. NO. 704, 73d Cong., 2d Sess. 13-14 (1934).

<sup>3</sup>INT. REV. CODE OF 1954, § 1001 provides in part:

(a) COMPUTATION OF GAIN OR LOSS. - The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain . . . .

<sup>4</sup>INT. REV. CODE OF 1954, § 1002 states:

Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized.

<sup>5</sup>INT. REV. CODE OF 1954, § 1002.

<sup>6</sup>INT. REV. CODE OF 1954, § 361(a) reads:

(a) GENERAL RULE. - No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance

of gain or loss to a corporation, a "party to a reorganization" as defined by § 368(b),<sup>7</sup> upon the exchange of property for stocks or securities of another corporation, where certain qualifications are met.<sup>8</sup> "Reorganization" is then defined for tax purposes by § 368(a)(1)(A) to include a statutory merger or consolidation,<sup>9</sup> a requirement calling for compliance with the corporation laws of the applicable jurisdiction.<sup>10</sup>

In addition to the statutory requirement outlined in § 368(a)(1)(A), two specific inquiries have been developed judicially to restrict the application of the § 361 exception. These inquiries of "business purpose"<sup>11</sup> and "continuity of interest"<sup>12</sup> were designed to

of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.

INT. REV. CODE OF 1954, § 368(b) defines a party to a reorganization to include:

- (1) a corporation resulting from a reorganization, and
- (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

<sup>7</sup>For the definition of a reorganization see INT. REV. CODE OF 1954, § 368(a)(1)(A), and text accompanying note 9 *infra*. The exchange must also occur pursuant to a "plan of reorganization," a term left undefined by the Internal Revenue Code.

<sup>8</sup>INT. REV. CODE OF 1954, § 368(a)(1)(A) reads:

(a) REORGANIZATION.—

(1) IN GENERAL. — For purposes of parts I and II and this part, the term "reorganization" means —

(A) a statutory merger or consolidation;

The Internal Revenue Code defines and uses the term reorganization in a special way, embracing a much wider variety of corporate readjustments than the layman's concept of it as the financial rehabilitation of a bankrupt enterprise. It is important to note that § 368(a) of the Code, which defines reorganization, is merely definitional and has no operative significance of its own. See B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 14.02, at 14-9 (3d ed. 1971) [hereinafter cited as BITTKER & EUSTICE].

<sup>10</sup>A statutory merger or consolidation is one which is "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." Treas. Reg. § 1.368-2(b) (1955).

<sup>11</sup>The business purpose test was first promulgated by the United States Supreme Court in the case of *Gregory v. Helvering*, 293 U.S. 465 (1935), in which the Court held that "a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either" was not intended to come within the corporate reorganization provisions of the Code. *Id.* at 469. The Internal Revenue Service had previously attempted to impose "a continuity of business enterprise" test which required the surviving corporation in a merger to continue essentially all of the businesses carried on by the acquired corporation before the merger. See Rev. Rul. 56-330, 1956-2 CUM. BULL. 204. Because the test was ineffective, however, it found little acceptance in the courts, see, e.g., *Bentsen v. Phinney*, 199 F. Supp. 363 (S.D. Tex. 1961), and has since been abandoned by the Internal Revenue Service, see Rev. Rul. 63-29, 1963-1 CUM. BULL. 77.

<sup>12</sup>The continuity of interest test was developed judicially to insure that the merger

insure that the diverse number of transactions which complied with the literal requirements of the corporate reorganization provisions,<sup>13</sup> but which were in essence mere sales, did not derive the tax benefits of § 361.<sup>14</sup>

In determining the existence of a continuity of interest, courts have often considered whether the nature of an individual's investment has been altered by the occurrence of the merger. Therefore, a comparison of the interests held by the taxpayer in both the acquired and the surviving corporations has been employed by various courts. Such an inquiry entails a consideration of the precise nature of the corporations involved. However, because the normal reorganization occurs between capital stock corporations, courts applying the continuity of interest requirement have been able to confine their examination to the relationship of the shareholders to the surviving corporation. Where the shareholder has been found to hold a "substantial proprietary interest"<sup>15</sup> after the merger, the reorganization has been deemed to satisfy the continuity of interest test since the shareholder's relationship to the acquiring corporation is substantially the same as the proprietary interest which necessarily existed before the merger. But the term "corporation" under the Code is broadly defined and extends the potential benefit of the § 361 postponement<sup>16</sup>

actually involved only a change in form or a paper transaction. *See* note 2 *supra*.

<sup>13</sup>*See* notes 9 and 10 *supra*.

<sup>14</sup>*See* BITTKER & EUSTICE, *supra* note 9 at ¶ 14.03. The judicial requirements of "business purpose" and "continuity of interest" are now formally embodied in the Treasury Regulations. Treas. Reg. § 1.368-1(b) (1955) reads in part:

The purpose of the reorganization provisions of the Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures made in one of the particular ways specified in the Code, as are required by business exigencies and which effect only a readjustment of continuing interest in property under modified corporate forms. Requisite to a reorganization under the Code are a continuity of the business enterprise under the modified corporate form, and . . . a continuity of interest therein on the part of those persons who, directly or indirectly, were the owners of the enterprise prior to the reorganization.

Satisfaction of the statutory requirements applicable to a merger or consolidation (note 10 *supra*), therefore, is insufficient by itself to obtain tax postponement under § 361 of the Code. *See*, 3 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 20.54 (1972), and text accompanying note 31 *infra*.

<sup>15</sup>The "substantial proprietary interest" rule has been the test traditionally applied by the courts to determine if the original continuity of interest requirement has been met. *See, e.g.*, *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404 (6th Cir. 1974).

<sup>16</sup>Section 361 of the Code does not provide for a tax exemption but merely post-

to non-capital stock corporations and associations.<sup>17</sup> In *West Side Federal Savings & Loan Association v. United States*,<sup>18</sup> the Sixth Circuit considered, within the parameters of the traditional substantial proprietary interest inquiry developed by the courts, whether a merger between a federal savings and loan association and a state savings and loan association could qualify for the § 361 exception. The court held that the merger qualified for tax-free treatment, yet the decision illustrates that the traditional substantial proprietary interest test may be unsuited to the non-capital stock situation.

In *West Side*, the surviving association, West Side Federal Savings and Loan Association, was operating under a charter of the Federal Home Loan Bank Board.<sup>19</sup> Pursuant to this charter West Side had numerous corporate powers.<sup>20</sup> Its sole authorized means of raising capital was the acceptance of "payments on savings accounts repre-

pones recognition of the tax liability until some future time when it is more convenient to tax the gain. See *BRITNER & EUSTICE*, *supra* note 9, at ¶ 14.01, at 14-3.

<sup>17</sup>INT. REV. CODE OF 1954, § 7701(a) states:

(3) CORPORATION.—The term "corporation" includes associations, joint-stock companies, and insurance companies.

As early as 1894, Congress recognized the unique position of associations, classifying them as quasi-corporations. See 26 CONG. REC. 6690 (1894).

<sup>18</sup>494 F.2d 404 (6th Cir. 1974).

<sup>19</sup>West Side Federal Savings was chartered pursuant to the Home Owners' Loan Act of 1933, 12 U.S.C. §§ 1461-68 (1970), as amended, 12 U.S.C. §§ 1461-68 (Supp. II, 1972), as amended, 12 U.S.C. §§ 1461-70 (Supp. III, 1973). Specifically, West Side was operating under Charter K. 496 F.2d at 406. The text of Charter K may be found in 12 C.F.R. § 544.1(b) (1974).

<sup>20</sup>Charter K (rev.), para. 3, 12 C.F.R. § 544.1(b) (1974) reads in part:

3. *Objects and powers.* The objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economical financing of homes; and in the accomplishment of such objects, it shall have perpetual succession and power: . . . (2) To sue and be sued, complain and defend in any court of law or equity; (3) To have a corporate seal, affixed by imprint, facsimile or otherwise; (4) To appoint officers and agents as its business shall require . . . (5) To adopt by-laws not inconsistent with the Constitution or laws of the United States and rules and regulations adopted thereunder and this charter; (6) To raise its capital, which shall be unlimited, by accepting payments on savings accounts representing share interests in the association; (7) To borrow money; (8) To lend and otherwise invest its funds; (9) To wind up and dissolve, merge, consolidate, convert, or reorganize; (10) To purchase, hold, and convey real and personal estate consistent with its objects, purposes, and powers; (11) To mortgage or lease any real and personal estate and take such property by gift, devise, or bequest; and (12) To exercise all powers conferred by law.

senting share interests in the association."<sup>21</sup> As a result of this restriction, West Side had no permanent shares of capital stock outstanding either before or after the merger.<sup>22</sup> However, all savings account holders and borrowers, as members of the association, were entitled to voting rights incident to their membership.<sup>23</sup> Furthermore, upon liquidation, dissolution, or winding up of the association, all of its shareholders were entitled "to equal distribution of assets, pro rata to the value of their savings accounts . . ."<sup>24</sup> Parma Savings Company, the Ohio-chartered savings and loan association<sup>25</sup> acquired by West Side in the merger had a limited amount of \$200 par-value capital stock outstanding, in addition to savings accounts.<sup>26</sup> The stockholders of

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<sup>21</sup>See note 20 *supra*. All corporations need some amount of capital with which to conduct their operations. For this purpose shares of stock are normally issued, representing interests in the corporation's surplus profits and in its assets upon dissolution. The amount of payments thus accumulated on the sale of shares of stock, is often termed "capital stock." See generally 11 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* §§ 5079-83 (perm. ed. 1971).

<sup>22</sup>Unlike the capital stock corporation, the savings association builds up its "capital account" by accepting deposits on share or savings accounts. Notes 20 and 21 *supra*. See generally Brunner, *Status of Mutual Savings Bank Depositors as Contrasted with Savings and Loan Shareholders*, 14 *BUS. LAW.* 1047 (1959); Prather, *Savings Accounts in Savings and Loan Associations*, 15 *BUS. LAW.* 44 (1959).

<sup>23</sup>Pursuant to West Side's charter, each holder of a savings account was entitled to one vote for each \$100 or fraction thereof of the withdrawal value of his account (in any event, not to exceed 50 votes). 494 F.2d at 406. Paragraph 4 of the charter also provided that each "borrowing member shall be permitted, as a borrower, to cast one vote, and to cast the number of votes to which he may be entitled as the holder of a savings account." Charter K (rev.), para. 4, 12 C.F.R. § 544.1(b) (1974). Account holders could vote for the members of the board of directors as the stockholders do in any capital stock corporation. *Id.*, at para. 5. They could also vote on any other question which was raised at a "regular or special meeting of the members." *Id.*, at para. 4.

<sup>24</sup>Borrowing members, as opposed to shareholders, do not share in the earnings of an association or in the distribution of its assets upon liquidation. Charter K (rev.), para. 10, 12 C.F.R. § 544.1(b) (1974).

<sup>25</sup>OHIO REV. CODE ANN., § 1151.02 (Page 1968). The primary distinction between a state-chartered savings association and a federally-chartered savings association is that the state association is not prohibited from issuing permanent capital stock. See, e.g., CAL. FIN. CODE § 6400 (West 1968) and § 6456 (Supp. 1974), *amending*, § 6456 (West 1968); ILL. ANN. STAT. ch. 32, § 761 (Smith-Hurd 1970); MASS. GEN. LAWS ANN. ch. 170, § 13 (1970); OHIO REV. CODE ANN. § 1151.20 (Page 1968); TEX. REV. CIV. STAT. art. 852a (1964), *as amended*, TEX. REV. CIV. STAT. art. 852a (Supp. 1974).

<sup>26</sup>In accordance with its by-laws Parma had issued and outstanding 877 shares of "permanent" stock and 13,779 shares of "installment" permanent stock. Installment permanent stock is stock on which regular installments or dues are paid until the stock has reached its maturity value. See, e.g., N.Y. BANK. LAW § 378(4)(a) (McKinney 1971). With respect to Parma's pre-merger balance sheet, it was shown that Parma

Parma enjoyed voting rights to the extent provided in the constitution of the association.<sup>27</sup>

Under the merger plan West Side acquired all the assets and assumed all the liabilities of Parma. Concurrently, those holding savings accounts in Parma received accounts in West Side with an equal withdrawal value.<sup>28</sup> Holders of permanent shares of outstanding capital stock in Parma received accounts in West Side with a withdrawal value of \$2,500 per share of stock surrendered.<sup>29</sup> West Side also acquired Parma's bad debt reserve,<sup>30</sup> using this reserve to offset its net income for the taxable year.<sup>31</sup> The government contested the offset; however, the Sixth Circuit affirmed the district court's decision in favor of West Side.<sup>32</sup> The Sixth Circuit held that the merger of both

carried approximately \$26,000,000 in savings accounts, \$178,202 of "Capital Stock," and \$1,690,022 of "Reserves and Undivided Profits." Brief for Appellant at 13-14, West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404 (6th Cir. 1974).

<sup>27</sup>See OHIO REV. CODE ANN. § 1151.20 (Page 1968). It is not clear from the facts of the case or the briefs submitted by both sides what voting rights the Parma stockholders or account holders did have. However, it is at least implicit from one point in the government's brief that the stockholders had voting rights. Brief for Appellant at 3, West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404 (6th Cir. 1974).

<sup>28</sup>494 F.2d at 406.

<sup>29</sup>*Id.* This would mean that stockholders of Parma were given \$2,226,947.50 in savings accounts in West Side. See note 26 *supra*.

<sup>30</sup>Under Ohio law all building and loan associations are required to maintain a reserve fund to cover any losses incurred as the result of bad debts, or debts which, for one reason or another, cannot be recovered by the bank. OHIO REV. CODE ANN. § 1151.33 (Supp. 1973). The Revenue Code allows a deduction "for a reasonable addition to a reserve for bad debts." INT. REV. CODE OF 1954, § 166(c). See also COMMITTEE ON SAVINGS AND LOAN ACCOUNTING AND AUDITING, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, AUDIT OF SAVINGS AND LOAN ASSOCIATIONS 61-65 (1973).

<sup>31</sup>As to such carryovers see INT. REV. CODE OF 1954, § 381, which provides that in a tax-free reorganization "the acquiring corporation shall succeed to and take into account," *inter alia*, the bad debt reserve and prior investment credits of the acquired corporation. See also INT. REV. CODE OF 1954, §§ 166(c), 593. Section 166(c) states:

(c) RESERVE FOR BAD DEBTS.—In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary or his delegate) a deduction for a reasonable addition to a reserve for bad debts.

<sup>32</sup>The present controversy arose from West Side's attempt to offset its income with the bad debt reserve of Parma. Upon administrative review of Parma's federal income tax return (for the year ending with its merger into West Side), however, the auditor charged West Side, "as a transferee of the assets of Parma . . . with Parma's obligation in its final year of existence to restore to income its bad debt reserve and excess investment credits, for which it had earlier taken deductions against current income." Brief for Appellant at 8 n.3, West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404 (6th Cir. 1974). West Side may escape from the obligation, as transferee of Parma, to restore these items to income if the merger between Parma and West Side qualifies as a reorganization. However, the auditor treated Parma's bad debt reserve

savings and loan associations was a tax-free reorganization and permitted West Side's acquisition of Parma's bad debt reserve free from any immediate tax liability because it had fulfilled both the business purpose and the substantial proprietary interest tests. Closer analysis of the opinion in *West Side* provides a clearer understanding of the reasons for the court's conclusions.

The Internal Revenue Service conceded that the transaction between West Side and Parma constituted a merger within the literal language of § 368(a)(1)(A) of the Code.<sup>33</sup> Furthermore, no question was ever raised as to the business purpose of the merger.<sup>34</sup> However, the government did contend that the additional requirement of a substantial proprietary interest had not been met.<sup>35</sup> The government based its contention on the assertion that the exchange by Parma stockholders of their \$200 par-value stock for accounts in West Side was a conversion of an equity interest into cash or its equivalent. Thus, the controversy in *West Side* focused on whether, after the merger, a proprietary interest in West Side existed sufficient to satisfy the substantial proprietary interest test. In deciding the issue, the Sixth Circuit examined the origin and subsequent application of this test by the courts.

The court recognized that the substantial proprietary interest test had its origin in a decision by the Second Circuit, *Cortland Specialty Co. v. Commissioner*.<sup>36</sup> In *Cortland*, the court held that the transfer

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as additional income to Parma and therefore West Side, as successor to Parma, was assessed and paid the resulting deficiency of \$839,381.14 in Parma's income taxes for such final year. Brief for Appellee at 2. West Side thereupon filed a claim for refund. On cross-motions for summary judgment in the district court, Judge Walinski held that the merger of Parma into West Side constituted a tax-free reorganization and that Parma's bad debt reserve and prior investment credits were carried over to West Side without creating any tax liabilities to either Parma or West Side. Brief for Appellee at 2-3. The Government appealed from this decision. See note 31 *supra*.

<sup>33</sup>A merger, to be effective, must be approved by the trustees of the merging corporations and a majority of the voting members of each corporation, OHIO REV. CODE ANN. ch. 1702, §§ 1702.41-44 (Page 1964). Although these sections apply to the mergers or consolidations of corporations, they have been held to apply to savings and loan associations as well.

In addition, the merger was approved "by the Superintendent of Building and Loan Associations of Ohio, following an official ruling by the Attorney General of Ohio appearing in 1967 Ohio Attorney General Opinions No. 67-059," and by the Federal Home Loan Bank Board. Brief for Appellee at 7, *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404 (6th Cir. 1974).

<sup>34</sup>See note 11 *supra*.

<sup>35</sup>See note 14 *supra*.

<sup>36</sup>60 F.2d 937 (2d Cir. 1932). In *Cortland* an agreement was entered into between Cortland Specialty Co. and the Deyo Oil Co. whereby Cortland was merged into Deyo.



of assets of one corporation to another corporation in exchange for cash and short-term notes did not constitute a tax-free reorganization within the scope of § 203 of the Revenue Act of 1926.<sup>37</sup> In making such a determination the court concluded that "a continuance of interest on the part of the transferor in the properties transferred" was implicit in the definition of a reorganization for purposes of tax-free status.<sup>38</sup> The Sixth Circuit in *West Side* further noted that the *Cortland* decision was cited with approval by the United States Supreme Court in *Pinellas Ice Co. v. Commissioner*.<sup>39</sup> In that case the property of two corporations was acquired by a third corporation in exchange for cash and short-term notes. The Court held that the secured short-term notes received were not securities and were properly regarded as the equivalent of cash. In applying the "continuance of interest" requirement promulgated by the Second Circuit in *Cortland*, the Supreme Court stated: "[c]ertainly, we think that to be within the exemption the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."<sup>40</sup>

The court in *West Side* then discussed numerous Supreme Court decisions which it interpreted as further defining the parameters of the substantial proprietary interest requirement. In *Nelson Co. v. Helvering*,<sup>41</sup> a newly formed corporation acquired substantially all of another corporation's property in exchange for \$2,000,000 cash and the entire issue of its non-voting preferred stock.<sup>42</sup> The Court held that the transaction qualified as a tax-free reorganization. Although it noted that the mere acquisition of the assets of one corporation by another is not a reorganization, the Court emphasized that the continuity of interest test had been met since the preferred stockholders held a substantial proprietary interest in the acquiring corporation,

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Pursuant to the agreement *Cortland* transferred to *Deyo* the greater part of its assets in exchange for \$53,070 in cash and \$159,750 in notes with maturity dates varying from two to fourteen months from the date of issuance.

<sup>37</sup>Section 361 of the 1954 Internal Revenue Code is identical to section 203(b)(3) of the Revenue Act of 1926.

<sup>38</sup>60 F.2d at 940.

<sup>39</sup>287 U.S. 462 (1933). In this case *Pinellas* transferred all its assets to *National Public Service Corp.* in exchange for \$400,000 in cash and deferred installments evidenced by *National's* six percent notes secured by notes of, or liens on, the property of other companies. *Id.* at 464.

<sup>40</sup>287 U.S. at 470.

<sup>41</sup>296 U.S. 374 (1935).

<sup>42</sup>296 U.S. at 376. In all, 12,500 shares of preferred stock were transferred by the new corporation to the *John A. Nelson Co.* At a par-value of \$100 per share this represented approximately three-fourths of the cash involved in the transaction.

regardless of their lack of voting rights.<sup>43</sup>

Two other Supreme Court decisions, decided on the same day as *Nelson*, were cited by the Sixth Circuit as a further illustration of the substantial proprietary interest requirement. In *Helvering v. Minnesota Tea Co.*,<sup>44</sup> the Supreme Court held that an exchange of assets by a corporation for stocks in one acquiring corporation and voting trust certificates in another, plus cash, qualified as a tax-free reorganization. In its opinion the Court stated that the interest acquired by the seller in the affairs of the surviving corporation "must be definite and material; it must represent a substantial part of the value of the thing transferred."<sup>45</sup> The Court also emphasized that the statute did not prohibit a change in the relationship between the pre-merger stockholders and the assets conveyed.<sup>46</sup>

The same result was reached in *Helvering v. Watts*.<sup>47</sup> In that case the stock of the acquired corporation was exchanged for stock of another corporation and for bonds of the acquired corporation guaranteed by the acquiring corporation.<sup>48</sup> The Supreme Court held that the bonds could not be treated as cash equivalent as the short-term notes in *Pinellas* were, and classified them as "securities" within the meaning of the Code.<sup>49</sup> Thus, the receipt of bonds in addition to stock, pursuant to a merger exchange, was held not to disqualify the transaction for tax-free treatment. However, in *LeTulle v. Scofield*<sup>50</sup> the Supreme Court qualified the *Watts* opinion by emphasizing that, where the consideration received in the exchange is wholly in the form of bonds, or partly in cash and partly in bonds, no proprietary interest in the enterprise is retained by the transferor.<sup>51</sup>

Having traced the development of the test, the Sixth Circuit cited

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<sup>43</sup>*Id.* at 377.

<sup>44</sup>296 U.S. 378 (1935).

<sup>45</sup>*Id.* at 385.

<sup>46</sup>*Id.* at 386.

<sup>47</sup>296 U.S. 387 (1935).

<sup>48</sup>In *Watts*, Ferro Alloys Corp. exchanged all its stock for shares of Vanadium Corp. valued at \$30 per share, and bonds of Ferro Alloys guaranteed by Vanadium in the amount of \$1,161,184.50. Ordinarily, one corporation has no power to guarantee the bonds of another, unless its charter or state law so provides. 6A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 2719 (perm. ed. 1968).

<sup>49</sup>296 U.S. 387, 389 (1935).

<sup>50</sup>308 U.S. 415 (1940).

<sup>51</sup>*Id.* at 420-21. The plan of reorganization in *LeTulle* called for the conveyance of all the properties owned by the acquired corporation to the acquiring corporation in exchange for \$50,000 in cash, and \$750,000 in bonds, payable serially over a period from January 1, 1933 to January 1, 1944. *Id.* at 416.

*Miller v. Commissioner*<sup>52</sup> and *Commissioner v. Segall*<sup>53</sup> as controlling in its jurisdiction with regard to the interpretation of the substantial proprietary interest requirement. Both cases involved the statutory merger of stock corporations. In *Miller* the Sixth Circuit held that a tax-free reorganization existed where the stockholders of the acquired corporation received cash and stock in the acquiring corporation.<sup>54</sup> The *Miller* court also stated that it is not necessary that the interest in the acquiring corporation be a controlling interest or that the relationship of the stockholders to the assets transferred continue substantially unchanged in order for § 361 to be applicable.<sup>55</sup> In *Segall*, the court reiterated the point that for a statutory merger to qualify for § 361 treatment the transferor must retain a proprietary interest in the surviving corporation. The court held that the exchange of the assets of the acquired corporation for cash, gold debentures, and a promissory note in the amount of \$100,000 did not qualify as a tax-free reorganization.<sup>56</sup> Relying on *LeTulle v. Scofield*, the Sixth Circuit stated that an essential element in a § 361 reorganization is the retention by the transferor of "a substantial and material continuity of interest in the property transferred."<sup>57</sup> From these cases, the Sixth Circuit in *West Side* derived the requirement to be imposed in the present case: "[t]he interest which the transferor or its shareholders acquire must be at least in substantial part a proprietary or equity interest and where only cash or debt obligations of the transferee are received there is no qualifying reorganization."<sup>58</sup>

Recognizing the unique capital structure of the savings and loan association, the Sixth Circuit initiated its analysis of the facts in *West Side* by examining the definitional provisions of § 7701 of the Code. Although the government in *West Side* conceded that the Code's definition of corporations includes associations,<sup>59</sup> and that the Code's definition of stock includes shares in an association,<sup>60</sup> it contended that the share interests in *West Side* received by the former stockholders of Parma did not constitute a substantial proprietary

<sup>52</sup>84 F.2d 415 (6th Cir. 1936).

<sup>53</sup>114 F.2d 706 (6th Cir. 1940).

<sup>54</sup>The court did not attach any significance to the fact that a minority of stockholders in the acquired corporation received solely cash. 84 F.2d at 418-19.

<sup>55</sup>84 F.2d at 418-19.

<sup>56</sup>114 F.2d at 708-09.

<sup>57</sup>*Id.* at 708.

<sup>58</sup>494 F.2d 404, 409 (6th Cir. 1974).

<sup>59</sup>INT. REV. CODE OF 1954, § 7701(a)(3).

<sup>60</sup>INT. REV. CODE OF 1954, § 7701(a)(7) states:

(7) STOCK.—The term "stock" includes shares in an association, joint-stock company, or insurance company.

interest.<sup>61</sup> However, the court emphasized the fact that the members of a federal savings and loan association have a hybrid status, being both creditors as holders of savings accounts, and holders of equity as members possessing certain proprietary rights.<sup>62</sup> In determining whether the equity status of shareholders in the association was sufficient to fulfill the substantial proprietary interest requirement, the Sixth Circuit examined both the applicable Revenue Rulings and cases.

The Internal Revenue Service has stated its position with respect to statutory mergers of savings and loan associations in three rulings.<sup>63</sup> In both the case of a statutory merger of two mutual savings and loan associations,<sup>64</sup> and of a savings association having only savings shares into one having savings shares and guarantee shares,<sup>65</sup> the Service has held that the requirements of a tax-free reorganization were met. However, in Rev. Rul. 69-6, a merger substantially similar to that in *West Side* was held not to fulfill the substantial proprietary interest requirement although it complied with the definitional requirement of § 368.<sup>66</sup> The Sixth Circuit rejected the conclusion of Rev. Rul. 69-6 on the ground that the basic premise relied on therein—that the obligation to deliver cash deposits in saving accounts is inseparable from the obligation to deliver a proprietary interest to the former shareholders of the acquired association—was inconsistent with the other Rulings.<sup>67</sup>

The Sixth Circuit also discussed three cases which considered the

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<sup>61</sup>Because the stockholders in Parma had a proprietary interest the government contended that a substantial proprietary interest must be retained in *West Side*. The government stated that the share accounts in *West Side* were not such a proprietary interest. 494 F.2d at 411.

<sup>62</sup>See note 23, and text accompanying note 24 *supra*. See also BITTKER & EUSTICE, *supra* note 9, at ¶ 4.03.

<sup>63</sup>Rev. Rul. 69-646, 1969-2 CUM. BULL. 54; Rev. Rul. 69-6, 1969-1 CUM. BULL. 104; Rev. Rul. 69-3, 1969-1 CUM. BULL. 103.

<sup>64</sup>Rev. Rul. 69-3, 1969-1 CUM. BULL. 103. See note 25 *supra*, and text accompanying note 131 *infra*.

<sup>65</sup>Rev. Rul. 69-646, 1969-2 CUM. BULL. 54. See note 25 *supra*, and text accompanying note 132 *infra*. Guarantee shares of a savings and loan association are fixed non-withdrawable investments which guarantee "to all other investors in the association a fixed rate of dividend or interest." BLACK'S LAW DICTIONARY 833 (4th ed. 1957). See *Stumph v. Wheat Belt Bldg. & Loan Ass'n*, 148 Kan. 25, 79 P.2d 896, 899 (1938).

<sup>66</sup>Rev. Rul. 69-6, 1969-1 CUM. BULL. 104. See text accompanying note 135 *infra*.

<sup>67</sup>494 F.2d at 409-10. *But see* text accompanying note 136 *infra*. In Rev. Rul. 69-6, 1969-1 CUM. BULL. 104 the proprietary interest held by account holders was treated as inseparable from the cash deposits which accumulated in his account. Conversely, the Service in Rev. Rul. 69-646, 1969-2 CUM. BULL. 54 treated the two interests as severable.

tax consequences of a savings and loan association merger. In *Everett v. United States*,<sup>68</sup> the Tenth Circuit dealt with a fact situation similar to that present in *West Side*.<sup>69</sup> However, the *Everett* court treated the transaction involved as a transfer of assets under § 368(a)(1)(C) of the Code rather than a merger or consolidation under § 368(a)(1)(A). Although the requirements of § 368(a)(1)(C) contain a somewhat stricter continuity of interest test,<sup>70</sup> the court held that savings shares in a mutual association constituted voting stock thereby qualifying the transaction for tax-free treatment. *Home Savings & Loan Association v. United States*<sup>71</sup> also involved the merger of two savings and loan associations. There it was held that an adequate proprietary interest existed since the Internal Revenue Service had expressed the same opinion on almost identical facts.<sup>72</sup>

<sup>68</sup>448 F.2d 357 (10th Cir. 1971).

<sup>69</sup>Although the state-chartered association involved in the *Everett* merger had issued permanent shares, 97 percent of the voting shares in the new association were represented by full paid shares and savings shares. The state association was organized pursuant to KAN. STAT. ANN. §§ 17-5201 to -5203 (1964), wherein full-paid shares and savings shares are identical to the accounts in *West Side*. KAN. STAT. ANN. §§ 17-5401 to -5421 (1964), *as amended*, KAN. STAT. ANN. §§ 17-5401 to -5413 (Supp. 1973). Pursuant to the merger agreement the holders of these shares received accounts in the federal savings and loan association equal in value to the full participation value of their shares in the state association, 448 F.2d at 359. *See* note 140 *infra*.

<sup>70</sup>*Compare* INT. REV. CODE OF 1954, § 368(a)(1)(A) *with* INT. REV. CODE OF 1954, § 368(a)(1)(C) which states in part:

. . .  
(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of substantially all of the properties of another corporation . . .

<sup>71</sup>223 F. Supp. 134 (S.D. Cal. 1963). The case involved a merger of two state-chartered savings and loan associations. One of the associations, Hollywood, was a wholly owned subsidiary of the other association, Home. Because of the relationship between the two associations, it was contended that the merger was actually a liquidation and was governed by § 332 of the 1954 Internal Revenue Code. Section 332 requires that the parent corporation be the owner of stock "possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote," in order for any gain or loss realized on the liquidation to be unrecognized. Although Home held all of the guarantee stock of Hollywood, it had no interest in Hollywood's share accounts which also constituted a large part of Hollywood's voting power. The court held that in order for the merger to qualify as a liquidation under § 332, the share accounts in Hollywood were to be treated as stock entitled to vote. To fulfill the 80 percent requirement in § 332, the court further held that Home had to possess 80 percent of the voting interests of the share accounts, indicating that the interest, represented by the guarantee shares in Hollywood, held by Home, was minimal. *See* note 140 *infra*.

<sup>72</sup>Rev. Rul. 69-3, 1969-1 CUM. BULL. 103. Under similar circumstances, the tax court in *Home Sav. & Loan Ass'n v. United States*, 73-2 U.S. Tax Cas. ¶ 9609 (C.D. Cal. 1973), stated that the owners of shares and certificates in a savings and loan

Despite this case law, the government in *West Side* argued that the requirement of a substantial proprietary interest had not been satisfied in the Parma-West Side merger for two reasons. First, the share accounts received in West Side should be treated as cash equivalent. Secondly, while the stockholders were the owners of Parma, their receipt of share accounts in West Side made them creditors of the association. The Sixth Circuit apparently considered that a determination that the account holders in West Side were not creditors of the association but were equity owners would necessarily require holding that the same share accounts were not the equivalent of cash. In refuting both contentions, the Sixth Circuit referred to paragraph 6 of the Charter of West Side,<sup>73</sup> wherein it was stated that applications for withdrawal by holders of savings accounts would not give them the status of creditors. The court also emphasized that the only proprietary interest possible in a mutual savings and loan association is a savings account, and such proprietary rights should not be ignored.<sup>74</sup> Perceiving the trend of the continuity of interest test to involve a focus on the nature of the interest received in the surviving corporation, the Sixth Circuit stated that the question involved was not "whether the shareholder of the merged corporation receives more or less of a proprietary interest than he surrendered."<sup>75</sup> Rather the analysis to be applied, according to the Sixth Circuit, was "to determine if a proprietary interest is received."<sup>76</sup> Stating that the savings accounts present in *West Side* represented such an interest, the court held that the Parma-West Side merger qualified as a tax-free reorganization under § 368(a)(1)(A) of the Code.

Although the Sixth Circuit in *West Side* presented several reasons

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association retained an equity interest which satisfied the continuity of interest requirement. The case involved the merger of two state-chartered associations, Pasadena and Anaheim, into a federally-chartered association, Home Savings. Both of the state-chartered associations had permanent shares of capital stock which represented a minimal interest in the association in comparison to the savings account interests held in each. Pasadena had 20,000 shares of guaranteed stock outstanding on its books valued at \$200,000. However, it also had 650,252 withdrawable shares, held by approximately 28,000 depositors, representing deposits of \$65,025,252.58. Anaheim had shares of guaranteed stock outstanding to the extent of 1,000 shares valued on the books at \$100,000. It also had 177,365 investment certificates held by approximately 6,800 depositors and representing deposits of \$17,736,544. See note 140 *infra*.

<sup>73</sup>Charter K (rev.), para. 6, 12 C.F.R. § 544.1(b) (1974) reads in part: "[h]olders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid and shall not become creditors."

<sup>74</sup>494 F.2d 404, 411 (6th Cir. 1974).

<sup>75</sup>*Id.*

<sup>76</sup>*Id.*

for treating the savings account holder as the holder of a proprietary interest, some doubt exists as to the validity of such a classification. The very definition of the word "hybrid" describing the nature of the account denotes the existence of different characteristics which, in the case of a mutual savings account, allow for differing conclusions regarding the nature of the interest involved. The Washington Supreme Court in *State ex rel. Graham v. City of Olympia*,<sup>77</sup> emphasizing that the association shareholder does not make a permanent contribution to capital as does the typical corporate stockholder, held that deposits in a savings association are not analogous to stock purchases. In addition, as early as 1889, the Massachusetts Supreme Court in *Atwood v. Dumas*<sup>78</sup> rejected the supposition that membership in a mutual savings and loan association automatically indicates non-creditor status. In that case, Justice Holmes concluded that the various characteristics of a share in a mutual association demonstrate that "the relation between [the association] and the [shareholder] is that of debtor and creditor."<sup>79</sup> Thus authorities exist questioning the Sixth Circuit's classification of the savings and loan shareholders as equity holders. Indeed, several important distinctions exist between a stockholder in a capital corporation, who holds a proprietary interest, and a shareholder in a mutual savings and loan association. Both the highly liquid nature of the savings account held by the shareholder, and the minimal risk assumed in holding such an account, make the shareholder more akin to a creditor of the association.

Specifically, the stockholder in a capital stock corporation occupies a relatively fixed position in that his investment cannot be withdrawn upon demand.<sup>80</sup> Conversely, the shareholder in a mutual asso-

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<sup>77</sup>80 Wash. 2d 672, 497 P.2d 924, 930-31 (1972).

<sup>78</sup>149 Mass. 167, 21 N.E. 236 (1889).

<sup>79</sup>21 N.E. at 237.

<sup>80</sup>See INT. REV. CODE OF 1954, § 385(b); BRTTKER & EUSTICE, *supra* note 9, at ¶ 4.05 at 4-15. The stockholder's "method of withdrawal" is by sale of his share of stock. However, the amount which the stockholder will receive on the sale depends on the amount a prospective buyer is willing to pay for it. See J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 281 (1968). The previous seller may have expressly warranted the value of the stock or guaranteed that it will be worth par, or any other specified sum, within a certain time. Ordinarily, however, a statement as to the intrinsic value is merely an expression of opinion not constituting a warranty where the seller does not knowingly make a false statement to an ignorant buyer. 12A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, § 5615 (perm. ed. 1972). Therefore, while the account holder in a savings association can draw on a certain fund in his account represented by his passbook (*see* note 81 *infra*), the stockholder must wait until he sells his stock before he can be considered to have "received" any income.

ciation can withdraw funds from his account at any time,<sup>81</sup> subject only to certain minimal restrictions.<sup>82</sup> These restrictions are not sufficient to prevent the "interest, dividends, or other earnings" payable on those accounts from being constructively received by the shareholder and treated as income for tax purposes.<sup>83</sup> Moreover, while the charter of a federal savings and loan association provides that dividends paid on accounts are to be declared by the board of directors of the association,<sup>84</sup> frequently a fixed percentage rate is set at which these dividends are computed.<sup>85</sup> The bondholder also receives a fixed return on his "investment" by receiving interest payments thereon.<sup>86</sup> Thus the similarities between a shareholder in an association and a creditor in a capital stock corporation are seemingly quite substantial, thereby raising questions as to the soundness of the Sixth Circuit's conclusion.<sup>87</sup>

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<sup>81</sup>Charter K (rev.), para. 6, reads in part: "Upon receipt of a written request from any holder of a savings account of the association for the withdrawal from such account of all or any part of the withdrawal value thereof, the association shall within 30 days pay the amount requested . . ." Charter K (rev.), para. 6, 12 C.F.R. § 544.1(b) (1974). The use of the verb "shall" apparently indicates that the 30 day limit imposed is at most an outer limit.

<sup>82</sup>The restrictions imposed include the limitation of withdrawing only \$1,000 at a time. Once having made a withdrawal the party must then wait until others on a withdrawal request list are satisfied before making a further withdrawal. However, the restrictions only take effect if the association is unable to satisfy all its withdrawal demands within the 30 day limit. *Id.*

<sup>83</sup>Treas. Reg. § 1.451-2(a) (1971) provides that income is constructively received by a taxpayer although not actually in his possession, when it is "credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time." The only exceptions to this rule occur when the "taxpayer's control of its receipt is subject to substantial limitations or restrictions." The requirements of notice of intention to withdraw in a savings and loan association, and withdrawal in increments of \$1,000 are, however, not within these exceptional circumstances. *Id.*

<sup>84</sup>Charter K (rev.), para. 10, 12 C.F.R. § 544.1(b) (1974). Charter N (rev.), 12 C.F.R. § 544.1(a) (1974), under which a federal savings and loan association may operate, also provides that dividends on accounts are to be declared by the board of directors. *Id.* at para. 10.

<sup>85</sup>See UNITED STATES SAVINGS AND LOAN LEAGUE, SAVINGS AND LOAN FACT BOOK 13, 16-17, 75 (1973).

<sup>86</sup>See BITTKER & EUSTICE, *supra* note 9, at ¶ 4.03, at 4-8.

<sup>87</sup>A bond contains an unconditional obligation to pay a fixed sum, on or before a fixed maturity. See *Id.* The value of a share of stock, however, fluctuates. It has been said that the value of a share of stock is a function "of the current and expected future earnings and dividends of the company and the perceived risk of the stock on the part of investors." J. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 281 (1968). The projected earnings of a firm are capitalized at a certain rate and then discounted to present value, representing the value of the stock today. See 1 A. DEWING, FINANCIAL POLICY OF CORPORATIONS, 281-82, 287-92, 390-91 (5th ed. 1953); A. ALCHIAN & W. ALLAN,



The court's position also becomes suspect upon comparison of the risks involved in liquidation of the capital stock corporation and default of an association. Indeed the shareholder in an association assumes even fewer risks than those assumed by the typical corporate bondholder. Unlike the capital stock corporation where insolvency occurs if its assets are insufficient to meet current liabilities, a savings and loan association is deemed insolvent when its funds are insufficient to pay its general creditors and its shareholders the amount of their contributions dollar for dollar.<sup>88</sup> Furthermore, while the contribution of the corporate creditor is a function of the financial condition of the corporation, the investment of a shareholder in a mutual association is at least partially insured.<sup>89</sup> Such security is wholly inconsistent with the risk element present in those investments which constitute a proprietary interest in most corporations.<sup>90</sup> In light of this, various decisions involving savings and loan associations have specifically stated that the shareholder in the association is a creditor and not the holder of a proprietary interest.<sup>91</sup>

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UNIVERSITY ECONOMICS 175-94 (3d ed. 1972). Comparison of these factors to the share account in a mutual savings and loan association indicates that the share account more nearly resembles a debt obligation. The shareholder in a mutual association always has a specified sum in his account, known as the "withdrawal value," from which he may draw funds. 12 C.F.R. § 541.6 (1974). So long as the savings and loan association can meet withdrawal demands, it has a contractual obligation to pay the account holder any or all of the funds accumulated in his account. *Mengele v. Christiana Fed. Sav. & Loan Ass'n*, \_\_\_ Del. \_\_\_, 287 A.2d 395, 397 (1972). See Charter K (rev.), para. 6, 12 C.F.R. § 544.1(b) (1974). Thus, similar to the bond situation, the account holder is assured of receiving at least his withdrawal value, whereas the stockholder must rely on what sale of his share of stock will bring. See note 89 *infra*.

<sup>88</sup>*Wyman v. McKeever*, 239 Md. 130, 210 A.2d 537, 538 (1965).

<sup>89</sup>Section 405 of the National Housing Act provides for the insurance of accounts by the Federal Savings and Loan Insurance Corporation:

(a) Each institution whose application for insurance under this subchapter is approved by the [FSLIC] shall be entitled to insurance up to the full withdrawal or repurchasable value of the accounts of each of its members and investors . . . except that no member or investor of any such institution shall be insured for an aggregate amount in excess of \$20,000.

12 U.S.C. § 1728(a) (1970).

The insurance coverage has been increased from \$20,000 to \$40,000 providing greater security for deposits of savings and loan shareholders. H.R. 11221 was signed by the President on October 28, 1974, which took effect on November 27, 1974.

<sup>90</sup>See *BIRTKER & EUSTICE*, *supra* note 9, at ¶ 4.03.

<sup>91</sup>See, e.g., *In re Mulkins & Crawford Elec. Co.*, 145 F. Supp. 146, 147 (S.D. Cal. 1956); *In re Western States Bldg.-Loan Ass'n*, 50 F.2d 632, 633 (S.D. Cal. 1931); *Horn v. Woodard*, 151 Ind. 132, 50 N.E. 33, 34 (1898); *Benton's Apparel, Inc. v. Hegna*, 213 Minn. 271, 7 N.W.2d 3, 5-6 (1942); *Bell v. Bakerstown Sav. & Loan Ass'n*, 385 Pa. 158,

Nevertheless, certain courts dealing with savings and loan mergers have alleged that one of the important indicia of a proprietary interest in an association is the voting rights held by an investor.<sup>92</sup> In *Nelson Co. v. Helvering*,<sup>93</sup> however, the United States Supreme Court emphasized that voting rights were not a conclusive indication of whether a proprietary interest does or does not exist. Consequently, the Court held that the absence of voting rights did not prevent the owner of preferred stock from being deemed the holder of a substantial proprietary interest.<sup>94</sup> In addition, it appears questionable whether a bondholder in a capital stock corporation would acquire a proprietary interest in the corporation merely by being given voting rights in its affairs.

The Sixth Circuit in *West Side* made the additional argument that the Charter itself treated the shareholders as something other than creditors. Referring to a provision stating that “[h]olders of savings accounts for which application for withdrawal has been made shall remain holders of savings accounts until paid, and shall not become creditors,”<sup>95</sup> the court contended that the shareholders were clearly not to be treated as creditors.<sup>96</sup> However, there is some ambiguity in the purpose of the provision cited, which has prompted at least one court to reach a different interpretation. In *Family Savings & Loan Association Shareholders’ Protective Committee v. Stewart*,<sup>97</sup> the Maryland Supreme Court held that shareholders were creditors of the association despite a charter provision similar to the one in *West Side*. The court saw the obvious purpose of the Charter as being to “insure equality of treatment of all free shareholders up to the time funds were actually withdrawn from the association.”<sup>98</sup> The court reasoned that any preferential treatment of one account holder over another, by virtue of his application for withdrawal, would destroy the notion of “mutuality” in a savings and loan association.<sup>99</sup> Because

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122 A.2d 411, 413 (1956); *State ex rel. Wicks v. Puget Sound Sav. & Loan Ass’n*, 8 Wash. 2d 599, 113 P.2d 70, 71 (1941).

<sup>92</sup>See, e.g., *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971); *Home Sav. & Loan Ass’n v. United States*, 223 F. Supp. 134 (S.D. Cal. 1963).

<sup>93</sup>296 U.S. 374 (1935).

<sup>94</sup>*Id.* at 377.

<sup>95</sup>Charter K (rev.), para. 6, 12 C.F.R. § 544.1(b) (1974).

<sup>96</sup>494 F.2d at 411.

<sup>97</sup>241 Md. 89, 215 A.2d 726 (1966).

<sup>98</sup>215 A.2d at 730.

<sup>99</sup>The term “mutuality” in a savings and loan association refers to the fact that all members are in *common membership* in the association, no one having preference over other members. Prather, *Savings Accounts in Savings and Loan Associations*, 15 Bus. Law. 44, 52 (1959).

the purpose of the Charter provision is to preserve mutuality, which is a concept relating to the relationship of the shareholders among themselves, it has no application to determining whether the shareholder is an equity holder, since this involves an inquiry into the relationship of the shareholder to the association. In light of this analysis the Sixth Circuit's reliance on the quoted provision to indicate the existence of a proprietary interest is at least questionable.

Further doubts as to the validity of the Sixth Circuit's classification of shareholders in a savings association as holders of a proprietary interest are raised by the Internal Revenue Code. Under the Code share accounts in a savings and loan association are apparently treated in the same manner as debt obligations in a capital stock corporation. Section 163 of the Code allows as a deduction from gross income "all interest paid or accrued within the taxable year on indebtedness,"<sup>100</sup> while dividends paid by corporations on shares of stock are not deductible but are to be treated as income.<sup>101</sup> Similarly, § 591 of the Code allows "dividends or interest" paid on "deposits or withdrawable accounts" as deductions to the mutual association in computing its taxable income.<sup>102</sup> While the technical term "dividends" is used in the section, a report by the Senate Finance Committee indicated that it was intended that those payments receive the same tax treatment as interest on deposits in commercial banks.<sup>103</sup>

From the foregoing analysis it is apparent that arguments for classifying account holders in a mutual association as proprietary interest holders or for treating them as creditors are equally tenable. This raises the possibility of inconsistent decisions regarding the nature of the savings and loan association shareholder's interest. Such inconsistencies create further confusion with respect to the applica-

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<sup>100</sup>INT. REV. CODE OF 1954, § 163(a) provides in pertinent part: "[t]here shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

<sup>101</sup>INT. REV. CODE OF 1954, §§ 301, 316. See note 140 *infra*.

<sup>102</sup>INT. REV. CODE OF 1954, § 591 reads in pertinent part:

In the case of mutual savings banks, [and] cooperative banks . . . there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts, if such amounts paid or credited are withdrawable on demand subject only to customary notice of intention to withdraw.

The original language of § 591 was amended to include "or interest." Act of Oct. 16, 1962, Pub. L. No. 87-834, § 6, 76 Stat. 984. Apparently Congress intended to avoid the issue of whether payments on accounts constituted dividends in order to be covered by the section.

<sup>103</sup>S. REP. NO. 1881, 87th Cong., 2d Sess. 49 (1962).

tion of the § 361 exception to the savings and loan association merger situation.<sup>104</sup> Additionally, since the traditional classifications in a capital stock corporation have been applied by the courts to the savings association situation, it is conceivable that the conclusions concerning these "hybrid" accounts may be applied to capital stock corporation reorganizations. Therefore, using the savings account analogy, the same inconsistent results could occur in the corporate situation. In particular, the growth of conglomerate acquisitions has prompted the growth of various hybrid securities whereby taxpayers seek to exploit the tax advantages of debt without being burdened by its nontax restrictions.<sup>105</sup> This is particularly true in corporations with thin capitalization<sup>106</sup> where the debt to equity ratio is high.<sup>107</sup> Although the debt obligations have all of the formal characteristics of debt instruments, the problem arises in determining if they should be treated as stock for tax purposes in light of the corporation's small amount of equity.

In terms of the reorganization situation, however, attempting to classify these instruments as debt or equity adds to the confusion. Moreover, instruments may be created which lack any indication of a debt or proprietary interest, and therefore, may be even more difficult to classify under traditional corporate concepts. For example, in *Stroh v. Blackhawk Holding Corp.*,<sup>108</sup> a corporation had issued two classes of stock, Class A and Class B. Although the Class A stock had the normal rights and privileges appurtenant to a proprietary interest, the Illinois Supreme Court faced a more difficult problem determining whether the Class B stock actually represented an equity interest. Holders of Class B stock possessed no rights in the earnings or in the assets of the corporation either upon voluntary or involuntary liquidation, or otherwise, and enjoyed no preemptive rights. The shareholders' sole right in the corporation was the right to vote their shares. Although the court held that the holders of Class B stock possessed a proprietary interest and were to be considered holders of

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<sup>104</sup>Because of the hybrid nature of a share account, the result reached, as demonstrated in the text, is contingent upon which characteristics the court emphasizes in its opinion.

<sup>105</sup>One important non-tax restriction inherent in the debt is its impairment of future borrowing capacity. See BITTKER & EUSTICE, *supra* note 9, at ¶ 4.03.

<sup>106</sup>Thin capitalization exists in a corporation when the corporation has issued debt securities "in amounts which overwhelm the equity investment," for example, "bonds in the amount of \$99,000 plus common stock, against assets valued at \$100,000." BITTKER & EUSTICE, *supra* note 9, at ¶ 4.04(2), at 4-12.

<sup>107</sup>*Id.*

<sup>108</sup>48 Ill. 2d 471, 272 N.E.2d 1 (1971).

shares of stock within the meaning of the Illinois Business Corporations Act,<sup>109</sup> its decision reflects the difficulty of classifying such interest. Conversely, some courts have treated "preferred stock" as debt obligations, despite the existence of certain equitable characteristics, allowing the return to be deducted as interest payments from gross income.<sup>110</sup> Therefore, it is conceivable that an instrument could possess many of the superficial indicia of a proprietary interest and yet be, in essence, a debt obligation as in many savings and loan association cases.<sup>111</sup> Because of the unique capital structure existent in the mutual savings and loan association, application of any rigid guidelines more applicable to the capital stock corporation necessarily leads to value judgments by the courts and conflicting decisions. In light of these potential problems, the question of substantial proprietary interest should be modified to become more responsive to savings and loan association mergers.

In the absence of the "proprietary interest" inquiry the question must be raised as to how the "continuity of interest" test should apply to a merger involving savings and loan associations. The legislative history to § 361 suggests a possible answer. The first reorganization provision is found in the Revenue Act of 1918,<sup>112</sup> and its purpose was "to negative the assertion of tax in the case of certain purely paper transactions."<sup>113</sup> Thus, by postponing tax liability to a time when it would be more equitable to recognize the gains realized, Congress sought to avoid imposing undue tax burdens on mergers where there had been a mere change in the form of the business and the interest therein.<sup>114</sup> To insure the eventual recognition of a gain or

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<sup>109</sup>ILL. ANN. STAT. ch. 32 (Smith-Hurd 1970).

<sup>110</sup>See *Bowersock Mills & Power Co. v. Commissioner*, 172 F.2d 904 (10th Cir. 1949); *United States v. Title Guarantee & Trust Co.*, 133 F.2d 990 (6th Cir. 1943).

<sup>111</sup>See note 91 *supra*.

<sup>112</sup>Revenue Act of 1918, ch. 18, § 202(b), 40 Stat. 1060 reads in part:

[W]hen in connection with the reorganization, merger, or consolidation of a corporation a person receives in place of stock or securities of no greater aggregate par or face value . . . no gain or loss shall be deemed to occur from the exchange, and the new stock or securities received shall be treated as taking the place of the stock, securities, or property exchanged.

<sup>113</sup>S. REP. NO. 617, 65th Cong., 3d Sess. 5-6 (1918).

<sup>114</sup>In 1933, the House Ways and Means Subcommittee recommended that § 112 of the Revenue Act of 1934, the predecessor of § 361 of the 1954 Code, be repealed for two reasons. The subcommittee hoped that repeal of the section would "close the door to one of the most prevalent methods of tax avoidance," and also simplify the tax law by eliminating this complex provision. J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 332 (1938), quoting WAYS & MEANS SUBCOMMITTEE, 73d Cong., 2d Sess., REPORT 8 (Dec. 4, 1933). Despite this recommendation, however, the House Ways and Means Committee was concerned that such a policy would impose undue burdens on reorganizations where a mere change in form was involved. See S. REP. NO.

loss, the Code provides generally for continuity of adjusted basis, so that the taxpayer's basis for the property *received* in the exchange will reflect his basis for the property *exchanged*.<sup>115</sup> By the presence of the words "received" and "exchanged" in § 358, which deals with the basis of property received in reorganizations, it seems clear that Congress hoped that courts would examine the taxpayer's interest in the surviving corporation vis-a-vis his interest in the acquired corporation.<sup>116</sup> This before-after type inquiry has appeared explicitly in some of the continuity of interest decisions. In fact, closer analysis of past implementation of the reorganization provisions by the courts reveals that despite the application of the substantial proprietary interest test, the essence of the inquiry has been to determine whether the shareholder's interest in his corporation before the merger remained substantially unchanged.

As originally conceived, the requirement of a continuity of interest involved a before-after comparison of the interests in both the acquired and the surviving corporations. The Second Circuit in *Cortland Specialty Co. v. Commissioner*<sup>117</sup> first set forth the test when it noted that the definition of a merger and consolidation as a tax-free reorganization required that the interests of the parties in the disappearing corporation must continue in the surviving or newly created corporation.<sup>118</sup> Thus, the test began as a before-after comparison between the interest held before the merger and that held subse-

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558, 73d Cong., 2d Sess. 16-17 (1934). Taxing West Side under the facts in the present case would impose just such an undue hardship. Under Charter K (rev.), para. 10, 12 C.F.R. § 544.1(b) (1971), West Side is required to maintain reserves as a certain percentage of its capital to protect itself and its insurer against potential losses. As a result of West Side's having assumed the losses which Parma may have incurred, and having received additional share accounts representing funds in excess of \$26,000,000, West Side will be required to substantially increase its reserves. Because the merger is in essence a paper transaction, West Side should be allowed to acquire Parma's bad debt reserve free of tax liability, since taxation would place an undue burden on West Side's ability to comply with the reserve requirements, contrary to the purpose of the reorganization provisions. See notes 31-32 *supra*.

<sup>115</sup>INT. REV. CODE OF 1954, §§ 358, 362. It is important to realize that the corporate reorganization provisions do not provide tax exemption but merely postpone tax consequences. See text accompanying notes 112-14 *supra*. See also BIRTKER & EUSTICE, *supra* note 9, at ¶ 14.01, at 14-3.

<sup>116</sup>The underlying assumption of the tax-free exchange provisions "is that the new property is substantially a continuation of the old investment still unliquidated; and, in the case of reorganizations, that the new enterprise, the new corporate structure, and the new property are substantially continuations of the old still unliquidated." Treas. Reg. § 1.1002-1(c) (1957).

<sup>117</sup>60 F.2d 937 (2d Cir. 1932).

<sup>118</sup>*Id.* at 939.

quent to the merger. The reason for the Second Circuit's discussion of equity or proprietary interests was only due to the fact that the merger involved the surrender of stocks for bonds pursuant to a plan of reorganization.<sup>119</sup> Because the stocks surrendered in the exchange clearly evidenced a proprietary interest, it was necessary only for the court in applying the continuity of interest test to determine if the bonds received after the merger also reflected a proprietary interest. Thus, the "substantial proprietary interest" rule arose as a result of this approach to the typical merger between capital stock corporations. Because subsequent cases in the development of the continuity of interest test were also generally concerned with mergers of capital stock corporations, there was no need to refer to the interest held before the merger since that interest was a stock interest which was inherently proprietary in nature.<sup>120</sup> Given the "before" interest, the courts were merely concerned with whether a proprietary interest which was substantial enough to provide the requisite continuity of interest existed subsequent to the merger. The development of a substantial proprietary interest test, therefore, did not eradicate the original before-after comparison as set forth in *Cortland*. Although the courts spoke only of a substantial proprietary interest after the merger, in making this inquiry they were in essence examining whether the shareholder's interest after the merger was substantially identical to that which preceded it. Accordingly, the courts phrased the question in terms of whether the prior equity holders "retained" a substantial proprietary interest in the surviving corporation.<sup>121</sup> Judicial use of the verb "retain" presupposes a carryover to the surviving corporation of an interest which existed in comparable form prior to the merger.

Some confusion with respect to the continuity of interest rule arose when the courts dealt with mergers involving the receipt of bonds. In *Pinellas Ice Co. v. Commissioner*<sup>122</sup> an exchange of stock for cash and bonds occurred pursuant to a plan of reorganization.<sup>123</sup> In holding that the merger did not satisfy the continuity of interest rule, the United States Supreme Court implied that the receipt of bonds

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<sup>119</sup>See note 36, and text accompanying notes 36-38, *supra*.

<sup>120</sup>See, e.g., *United States v. Hendler*, 303 U.S. 564 (1938); *G. & K. Mfg. Co. v. Helvering*, 296 U.S. 389 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice Co. v. Commissioner*, 287 U.S. 462, 470 (1933) (*citing Cortland* with approval).

<sup>121</sup>See, e.g., *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951).

<sup>122</sup>287 U.S. 462 (1933).

<sup>123</sup>See note 39 *supra*, and accompanying text.

in exchange for stocks might fulfill the requirements of the continuity of interest test if the bonds had a sufficiently far-off maturity date. In a later case, *Helvering v. Watts*,<sup>124</sup> the Supreme Court held that guaranteed bonds<sup>125</sup> with terms of two months to seven years were not essentially the equivalent of cash as were the short-term notes in *Pinellas*.<sup>126</sup> In *Watts* the exchange of stock for common stock and the guaranteed bonds of the surviving corporation was held to constitute a tax-free reorganization under the Code. Thus, a distinction developed between short-term notes which were to be treated as cash, and long-term obligations more akin to "securities."<sup>127</sup> Although this left the courts with a clear answer at either extreme, no natural line of demarcation existed between those two extremes. Any decision to draw such a line would necessarily be an arbitrary one.

Recognizing the inconsistencies which would result from such arbitrary decisions, the Supreme Court in *LeTulle v. Scofield*<sup>128</sup> reiterated the basic premise of the continuity of interest test in reaching a solution. Although the Court held that the exchange of stock for bonds and stock, pursuant to a reorganization, fulfilled the necessary continuity of interest, it stated that if the only interest retained was a creditor interest, the continuity of interest has been broken. The Court reasoned that there must be some continuance of the proprietary interest represented in the shares of stock, and that bonds alone, even long-term ones secured by a mortgage, could not fulfill the requirement.<sup>129</sup> It appears, then, that although courts have made an inquiry only into the proprietary interest after a reorganization they never have abandoned the basic premise upon which the continuity of interest test rests, *i.e.*, that the interest of the shareholder after the merger must be essentially unchanged from that held before the merger.

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<sup>124</sup>296 U.S. 387 (1935).

<sup>125</sup>See note 48 *supra*.

<sup>126</sup>296 U.S. at 389.

<sup>127</sup>The 1954 Internal Revenue Code itself does not define securities; however, the Supreme Court in *Helvering v. Watts* treated the bonds in question as securities under the Revenue Act of 1924.

<sup>128</sup>308 U.S. 415 (1940). The Court in *LeTulle v. Scofield* specifically cited *Helvering v. Watts* with approval. *Id.* at 420 n.6. It is clear, therefore, that the decision did not overrule *Watts*. The Court concluded that in *Watts*, although bonds were received in the exchange, a proprietary interest was retained in the form of the stocks. However, where only bonds or a creditor's interest are received in the merger in exchange for stock, there is no continuance of a proprietary interest, and therefore, there can be no reorganization. From this analysis, it is clear that the United States Supreme Court implicitly applied the before-after test to determine whether the interest acquired equalled or essentially resembled the interest surrendered.

<sup>129</sup>*Id.* at 420.



Because traditional concepts of a proprietary interest are inapplicable to the share account in a mutual savings and loan association, it would seem that courts could benefit by utilizing a before-after test when examining savings and loan mergers for purposes of the § 361 exception. Not only would such an inquiry be consistent with the purpose of the reorganization provisions; it would reduce substantially the confusion of trying to classify a savings and loan share account. For example, if the before-after approach is employed, the apparent inconsistency which the Sixth Circuit in *West Side* saw in the three Revenue Rulings becomes reconcilable.<sup>130</sup> In Rev. Rul. 69-3,<sup>131</sup> the question presented was whether the merger of two mutual savings and loan associations qualified as a tax-free reorganization under § 368(a)(1)(A) of the Code. Although the Ruling recognized an equity interest in the mutual association on the part of the account holder, this conclusion was not the basis for its decision. Terming the exchange an "equity-for-equity exchange" the Ruling treated the merger as a reorganization for the simple reason that the interest held before the merger was essentially the same as that held after the merger. No substantive change had occurred in that the holders of accounts in the acquired association received accounts with equivalent funds in the surviving association.

A second Revenue Ruling has dealt with the merger of a savings and loan association having solely passbook accounts into a savings and loan association having both passbook accounts and guarantee shares. In Rev. Rul. 69-646<sup>132</sup> the plan of merger contemplated the exchange of passbook accounts identical to the exchange in Rev. Rul. 69-3 above. The account holders in the acquired association also received a stock certificate evidencing a number of guarantee shares in the surviving association.<sup>133</sup> Although guarantee shares were not involved in the merger discussed in Rev. Rul. 69-3, it was nonetheless concluded in 69-646 that the transaction was in essence "solely an equity-for-equity exchange that satisfies the continuity of interest requirements." Thus, again, the before-after comparison was recognized as a viable test and applied thereby granting the merger tax-free status as a reorganization.<sup>134</sup>

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<sup>130</sup>See text accompanying note 67 *supra*.

<sup>131</sup>Rev. Rul. 69-3, 1969-1 CUM. BULL. 103.

<sup>132</sup>Rev. Rul. 69-646, 1969-2 CUM. BULL. 54.

<sup>133</sup>The number of guarantee shares, in the surviving association was "equal to the fair market value of the shareholder's equity interest in the acquired association divided by the fair market value of the surviving association's guarantee shares." Rev. Rul. 69-646, 1969-2 CUM. BULL. 54, 55.

<sup>134</sup>The fact that guarantee shares were also received in the exchange should not

The facts present in Rev. Rul. 69-6,<sup>135</sup> were substantially different from the previous two Rulings. However, in light of the before-after test the three Rulings were clearly consistent, despite the contention by the Sixth Circuit that their conclusions and assumptions were in conflict.<sup>136</sup> The situation involved in Rev. Rul. 69-6 was essentially identical to that in *West Side* but the capital account of the acquired association primarily consisted of permanent shares of outstanding capital stock. Conversely, the major portion of Parma's capital account, in *West Side*, was represented by the withdrawable share accounts held by its shareholders rather than permanent shares. Despite the admission by the Internal Revenue Service in Rev. Rul. 69-6 that the withdrawable shares did constitute an equity interest, it concluded that the change in interest from permanent shares of stock to withdrawable shares was too substantial to satisfy the continuity of interest test. In reaching this result the Service compared the shareholder's interest prior to the merger to that interest he received as a result of the merger.

Furthermore, application of the before-after inquiry would avoid any confusion present in a capital stock corporation reorganization where the interests involved were similar to those in *Stroh v. Blackhawk Holding Corp.*<sup>137</sup> While the court, in that case, had difficulty in classifying one of the classes of stock under traditional corporate concepts, the need for classification could be avoided in a merger situation by simply applying a before-after comparison. Where stock is exchanged for the class of stock discussed in the *Stroh* case pursuant to a plan of reorganization, courts could avoid the question of whether the *Stroh* type stock was proprietary in nature by simply comparing it to the stock held before the merger.

Although the Sixth Circuit in *West Side* considered itself locked into the "substantial proprietary interest" test,<sup>138</sup> it should have used

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disqualify the merger as a reorganization. The purpose of the corporate reorganization provisions is to negative the assertion of tax in a situation where there has been no "cashing in" of prior equity or other interests. See S. REP. NO. 617, 65th Cong., 3d Sess. 5-6 (1918); H.R. REP. NO. 704, 73d Cong., 2d Sess. 13-14 (1934). Where guarantee shares also have been received in the exchange it can hardly be said that there has been a change to a more liquid state which would be taxable as the receipt of cash. See 11 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5083 (perm. ed. 1971). See also H.R. REP. NO. 704, 73d Cong., 2d Sess. 12-14 (1934).

<sup>135</sup>Rev. Rul. 69-6, 1969-1 CUM. BULL. 104.

<sup>136</sup>See text accompanying note 67 *supra*.

<sup>137</sup>48 Ill. 2d 471, 272 N.E.2d 1 (1971).

<sup>138</sup>The Court in *West Side* considered the *Miller v. Commissioner* and *Commissioner v. Segall* cases, see text accompanying notes 52-53 *supra*, to be the controlling precedents in its jurisdiction, however, as the text points out, these cases

the before-after test. In applying the before-after comparison two important considerations should be observed about the *West Side* case. First, the interest held in Parma prior to the merger was substantially in the form of withdrawable share accounts. Whereas these accounts represented \$26,000,000 of Parma's capital, the permanent shares of stock outstanding issued by Parma were recorded on the balance sheet as having a value of only \$178,202.<sup>139</sup> Secondly, the interest received in *West Side* by the account holders and stockholders of Parma was also substantially in the form of share accounts. Upon consideration of these two facts, the merger of Parma into *West Side* resulted, essentially, in a mere change in form—one savings association into another with a corresponding change of accounts—without any change in substance. Because such an analysis satisfies the continuity of interest test in the form of a before-after comparison, the Sixth Circuit should still have approved the merger without any tax consequences.<sup>140</sup>

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dealt with the capital stock corporation situation and never explicitly rejected the before-after comparison.

<sup>139</sup>The \$178,202 of shares of stock outstanding represented approximately three-fourths of one percent of the funds in the share accounts indicating the minimal role these shares of stock held in the merger transaction.

<sup>140</sup>Closer observation of the facts of the savings and loan cases referred to by the Sixth Circuit in *West Side* reveals that those cases could also have decided the tax issue on the basis of a before-after test. In *Everett v. United States*, 448 F.2d 357 (10th Cir. 1971), the question of proprietary interest arose as the result of applying § 368(a)(1)(C) to a savings and loan merger involving voting stock. See note 69 *supra*. Had the court applied the before-after comparison under § 368(a)(1)(A) it apparently would have concluded that the continuity of interest requirement had been satisfied. Since withdrawable accounts represented 97 percent of the voting interest prior to the merger, and the entire interest in the acquiring association after the merger, no change in substance had occurred, merely a change in form. *Id.*

In *Home Sav. & Loan Ass'n v. United States*, 73-2 U.S. Tax Cas. ¶ 9609 (C.D. Cal. 1973), both the interests before and after the merger were substantially in the form of withdrawable share accounts. See note 72 *supra*. On the basis of this observation, the tax court could have concluded that the merger fulfilled the requisite continuity of interest, in that merely a change in the form in which the interests were held, had occurred.

Finally, in *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134 (S.D. Cal. 1963), the court apparently considered the before-after test when it stated:

After the merger of Hollywood and Home, the depositor-shareholders of Hollywood became the depositor-shareholders of Home. Thereafter, the depositor-shareholders of Hollywood had the same pro-rata continuing interest in Home as they had before the merger on a consolidated basis . . . . Under any theory, there was adequate continuity of interest.

*Id.* at 135. (Emphasis added).

Although it is clear in the *West Side* case that no tax liability should be imposed

A before-after approach would also provide an appropriate criterion for determining the tax liability of future savings and loan association mergers. The hybrid nature of a shareholder's interest in a mutual association makes a court's application of the substantial proprietary interest test difficult and leads to arbitrary classification of these interests as either creditor or equity. The principles of that test were readily adaptable to the ordinary stock corporation merger where the interest prior to the merger was without question a proprietary interest. Under those circumstances the only question requiring resolution was whether the interest retained in the acquiring corporation was also of a proprietary nature. However, with regard to a savings and loan association merger, it is often unclear as to whether the interest held prior to the merger was a proprietary interest. The before-after test makes a categorization of the shareholder's interest unnecessary because the only inquiry a court need make is whether the pre-merger interest is substantially similar to that received by the shareholder as a result of the merger. By focusing a court's attention on a comparison of interests rather than on an arbitrary classification of these interests, the before-after test would lead to a simpler, more rational, case by case determination of the tax status of savings and loan mergers, and would thereby promote consistency among the decisions of the various courts.

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on the associations involved, different considerations exist which may prompt a contrary tax treatment of the individual stock and shareholders. INT. REV. CODE OF 1954, § 354 provides for the nonrecognition of any gain or loss realized by an individual pursuant to the exchange of stocks or securities in a corporation for stocks or securities in another corporation involving a reorganization. Section 358 states that upon compliance with § 354, the basis, as determined in § 1012, of the interest held by the individual prior to the merger shall become the "substituted basis" of the interest acquired by the individual subsequent to the merger. See § 1016(b). Under this section, the former Parma stockholders would have a basis in their West Side accounts substantially lower than their \$2,500 withdrawal value. See text accompanying note 29 *supra*. Considering these circumstances it could be argued that each withdrawal from a West Side share account held by the former Parma stockholders should be a taxable event. INT. REV. CODE OF 1954, §§ 301, 302 provide for the taxation of distributions or redemptions by a corporation to its shareholders. Therefore, each withdrawal could be taxed by the Code to the extent of any gain or loss realized on the withdrawal. Cf. *Cohen v. Commissioner*, 77 F.2d 184 (6th Cir.), *cert. denied*, 296 U.S. 610 (1935).

