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"B" Reorganizations and the "Solely" for Voting Stock Problem

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I HAVE BEEN ASKED to write an article that in brief and simple terms explains the "B" reorganization definition to general practitioners, and which, if possible, also focuses upon something of significance to practitioners who are familiar with the intricacies of the federal income tax law.

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There are a number of extensive and excellent articles on "B" reorganizations, to which the reader with an actual stock acquisition problem is referred.[1] In this brief article I shall comment further upon the "creeping control" problem in "B" reorganizations which I have dealt with at length in an earlier article[2] and which continues to trouble those of us who must deal with the unfortunate Treasury regulations on the subject.

Section 368(a)(1)(B) of the *Internal Revenue Code* defines as a tax-free "reorganization"

> [T]he acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control[3] of such other corporation (*whether or not such*

[1] Darrell, *The Use of Reorganization Techniques in Corporate Acquisitions*, 70 HARV. L. REV. 1183 (1957); Kanter, *Cash in "B" Reorganization: Effect of Cash Purchases on "Creeping" Reorganization*, 19 TAX L. REV. 441 (1964); Vernava, *The Howard and Turnbow Cases and the "Solely" Requirement of B Reorganizations*, 20 TAX L. REV. 387 (1965).

For a detailed analysis of alternative methods of bringing the newly acquired subsidiary into the acquiring parent, and the problems attendant thereto, see MacLean, *"Creeping Acquisitions,"* 21 TAX L. REV. 345 (1966); Trimble, *Creeping Control: An Analysis of Tax Problems of the Multi-Stage Acquisition*, 28 J. TAXATION 135 (1968).

[2] Merritt, *Tax-Free Corporate Acquisitions — The Law and the Proposed Regulations*, 53 MICH. L. REV. 911 (1955).

[3] INT. REV. CODE OF 1954, § 368(c) [hereinafter cited as CODE] defines "control" as "the ownership of stock possessing at least *80 percent of the total combined voting power of all classes of stock entitled to vote* and at least 80 percent of the total number of shares of all other classes of stock of the corporation." (emphasis added).

Note that 80 percent of each class of voting stock of the acquired corporation is not needed, but rather only 80 percent of the total combined voting power of all voting

> *acquiring corporation had control immediately before the acquisition).* [Emphasis added.]

The parenthetical expression is the so-called "creeping control" provision. In effect, the "creeping control" provision treats as if it were acquired in exchange for voting stock, for "B" reorganization definitional purposes, any stock of a corporation which is acquired by another corporation prior to the transaction which results in the latter acquiring (*solely* for its voting stock) sufficient additional shares of the former to give it "control." Thus, section 368(a)(1)(B) permits a tax-free acquisition of corporate stock (voting or nonvoting) "in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months,"[4] if the stock so acquired (if acquired solely for voting stock) plus stock *previously* acquired (no matter how acquired), represents the requisite 80 percent needed for "control." It is no longer necessary, as it may have been under the 1939 Code, for the stock previously acquired (in an independent transaction) to have also been acquired solely for voting stock. However, the "series of transactions taking place over a relatively short period of time" language in the Treasury regulations, interpreting the "creeping control" provision which is intended to grant relief from a burdensome result under the 1939 Code, can itself inflict unexpected tax burdens on the shareholders of the acquired corporation. Let us see how.

The example of "creeping control" given in the Treasury regulations is troublesome. It reads:

> Corporation A purchased 30 percent of the common stock of Corporation W (the only class of stock outstanding) for cash in 1939. On March 1, 1955, Corporation A offers to exchange its own voting stock for all the stock of Corporation W tendered within 6 months from the date of the offer. Within the 6 months' period Corporation A acquires an additional 60 percent of the stock of Corporation W solely for its own voting stock, so that it owns 90 percent of the stock of Corporation W. No gain or loss is recog-

classes. As to nonvoting stock, the statute seems to require acquisition of only 80 percent of the total number of shares of all classes of nonvoting stock without regard to fair market values. However, Rev. Rul. 59-259, 1959-2 CUM. BULL. 115, rules (erroneously in my opinion) that the acquiring corporation must secure at least 80 percent in number *of each class* of nonvoting stock. A contrary view to Revenue Ruling 59-259 appears to have been taken in Reg. 62, art. 1566(c), *Example* (3). *See* A. BAAR & G. MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS 157-58 (1935).

[4] Treas. Reg. § 1.368-2(c) (1955). For a discussion of a "single transaction" see H.R. REP. NO. 1337, 83d Cong., 2d Sess. A132-33 (1954). *See also* Merritt, *Tax-Free Acquisition of Corporate Business*, N.Y.U. 13TH INST. ON FED. TAX. 693, 723-25 (1955).

> nized with respect to the exchanges of stock of Corporation A for stock of Corporation W. For this purpose, it is immaterial whether such exchanges occurred before Corporation A acquired control (80 percent) of Corporation W or after such control was acquired. If Corporation A had acquired 80 percent of the stock of Corporation W for cash in 1939, it could likewise acquire some or all of the remainder of such stock solely in exchange for its own voting stock without recognition of gain or loss.[5]

Why the 16-year spread between the time of acquisition of stock for cash (1939) and the time of acquisition of additional stock constituting "control" solely for voting stock (1955)? This is a good "safe" separate transaction example, but hardly a guide to the perplexed.

Suppose Corporation *P* acquires, for cash, either in the open market or through a private placement, stock of Corporation *S*. Thereafter, Corporation *P* for the first time makes a tender offer to the general public to acquire additional shares solely for a part of its voting stock. Under these facts, is the initial acquisition for cash to be regarded as a separate transaction? If not, does this mean that no shares can ever, with reasonable assurance, be acquired for cash by a corporation which contemplates the possibility of making a tender offer within the next several years without the corporation being in danger of failing to qualify for "B" reorganization treatment? Even if the acquisition for cash were not regarded as a separate transaction, would the tender offer nevertheless result in a tax-free exchange of shares under section 368(a)(1)(B) if, as a result of such offer an additional 80 percent of Corporation *S*'s stock were acquired solely for voting stock of Corporation *P*? Or would the cash transaction taint the later transaction, even though the tender offer, standing alone, resulted in the acquisition of "control" solely for voting stock?

Whether the two transactions will be treated as separate for advance rulings purposes, or whether this will be considered to be a question of fact as to which no private ruling letter will be issued in advance, is likely to be a matter of great concern. How does one, soliciting the tender of shares, write an effective as well as accurate prospectus in such circumstances, if the Revenue Service will not rule (even apart from the question of whether it will rule *promptly*), or if it rules that the tender offer will not result in tax-free exchanges? This latter situation appears to be what happened when Solitron Devices, Incorporated recently attempted to acquire

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[5] Treas. Reg. § 1.368-2(c) (1955).

control of Amphenol Corporation through a stock-for-stock tender offer.[6]

Less than a month before it made its tender offer, Solitron bought a small amount (less than 1 percent) of the outstanding stock of Amphenol for cash through a brokerage house. An Amphenol shareholder, seeking an advance ruling as to the tax consequences of accepting the tender offer, indicated to the Reorganization Branch of the National Office of the Internal Revenue Service that "a portion of such Amphenol stock was purchased by Solitron with the subsequent acquisition of Amphenol in mind."[7] The Reorganization Branch, in its ruling letter, treated the cash purchase and the subsequent acquisition of stock by Solitron as a result of the tender offer, as part of a single plan to acquire control of Amphenol, with the result that the tender offer was held to not meet the "B" reorganization rules "since the exchange is not solely for voting stock of Solitron."[8]

Thus, in the Internal Revenue Service's view, a cash purchase, followed by a tender offer of a stock-for-stock exchange, may result in a taxable transaction, unless the tender offer and the cash purchase are widely separated in time and are clearly independent transactions. Conversely, where the requisite 80 percent "control" of a corporation is acquired solely for voting stock of the acquiring corporation, thus meeting the "B" reorganization rules, the "B" reorganization may nevertheless *retroactively* be disqualified if subsequently the acquiring corporation acquires additional shares of the acquired corporation for cash. Therefore, unless the exchanging shareholders in a "B" reorganization obtain a warranty from the acquiring corporation that it has not in the past and will not in the future acquire additional shares of the acquired corporation for cash in a transaction which would have the effect of disqualifying the stock-for-stock exchange as a tax-free exchange, or, even better, that it has not acquired and will not acquire such stock for cash under any circumstances, the exchanging shareholders can not be certain that their acceptance of a tender offer will result in a tax-free exchange.[9]

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[6] *See* Letter from John F. Bogaard, Chief, Reorganization Branch of the Internal Revenue Service, to Richard E. Hall, Feb. 21, 1968.

[7] *Id.*

[8] *Id.*

[9] *See* MacLean, *supra* note 1, at 368-69. The warranty should be even broader, and refer to any act which would disqualify the exchanges pursuant to the tender offer as taxfree under CODE § 368(a)(1)(B). For example, a subsequent bringing of the assets

One way the acquiring corporation may be able to live with such a warranty would be to have the *acquired* corporation redeem for cash any shares which may become available after the "B" reorganization takes place. Such an acquisition for cash should not disqualify the "B" reorganization, even if accomplished prior to the stock-for-stock exchange,[10] provided that sufficient shareholders participate in the stock-for-stock exchange to meet the "continuity of interest" test.[11]

Granted the assumption in the Solitron-Amphenol ruling that the acquisition of Amphenol stock by Solitron for cash was part of a plan of Solitron to later acquire "control" of Amphenol through a stock-for-stock tender offer, I would like to suggest that the ruling is wrong. This suggestion accords with a thesis of an earlier article of mine,[12] which has been endorsed by subsequent writers,[13] and which I will briefly further develop here.

Howard v. Commissioner[14] held (under the 1939 Code) that there could be no "B" reorganization where some stock of the acquired corporation was acquired for cash, even though at the same time "control" was acquired solely for voting stock. Although neither the Tax Court's nor the Seventh Circuit's opinion attached significance to this fact, it appears that in the *Howard* case what was involved was the acquisition of 79.82 percent of Binkley Coal Company's common stock (3,683 shares) solely for voting stock of Truax-Traer Coal Company. In addition, 18.01 percent of the Binkley shareholders (831 shares) received solely cash, and Parsons College, a 2.17 percent shareholder of Binkley (100 shares), received Truax-Traer stock for 17 Binkley shares *plus cash* for 83 shares of Binkley stock.[15] If the acquisition of the 100 shares of Binkley common stock owned by Parsons College were treated as a

of the acquired corporation into the acquiring corporation could under some circumstances destroy the "B" reorganization. *See* MacLean, *supra* note 1; Trimble, *supra* note 1.

10 Rev. Rul. 68-285, 1968 INT. REV. BULL. NO. 23, at 17. The acquiring corporation may not pay the dissenting shareholders nor reimburse the acquired corporation for its payments to the dissenting shareholders.

11 *See* Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232, which sets forth a 50 percent continuity of interest rule for advance rulings purposes.

12 *See* Merritt, *supra* note 2.

13 *See* Kanter, *supra* note 1; Rosenzweig, *The "Boot" Peril: What is "Solely" Under Section 368(a)?*, N.Y.U. 24TH INST. ON FED. TAX. 995 (1966); Vernava, *supra* note 1.

14 238 F.2d 943 (7th Cir. 1956), *rev'g* 24 T.C. 792 (1955).

15 Parsons College exchanged 17 shares of Binkley common stock for 544 shares of Truax-Traer, and also sold 83 shares of Binkley common stock for cash at a price of $400 per share, or a total price of $33,200. Howard v. Commissioner, 24 T.C. 792, 800 (1955).

unitary transaction, namely, as if all 100 shares were acquired from Parsons College for Truax-Traer stock *plus* cash — in which event 80 percent "control" would not have been acquired by Truax-Traer *solely* for a portion of its voting stock — there would clearly have been no "B" reorganization. Nevertheless, the documentation of the exchange and purchase offers in *Howard* was carefully drawn to preclude such an interpretation, and the courts did not rest their decisions upon (or even discuss) this point.

The Seventh Circuit decided that a nontaxable exchange took place in the *Howard* case even though it agreed with the Tax Court that the "B" reorganization definition had not been met. This latter proposition was based on a so-called "but for" interpretation of the "boot" provisions of the 1939 Code,[16] the details of which are not important to this discussion, because the court's interpretation was specifically rejected by the Supreme Court of the United States in *Turnbow v. Commissioner*.[17] What is important here, however, is that in the *Turnbow* case the Supreme Court made it very clear that it was not passing upon the interpretation of the "B" reorganization definition in *Howard*, the validity of which it left an open question.[18] In this connection it is significant that in its brief before the Supreme Court in *Turnbow* the Government stated:

> It cannot be said with certainty . . . that there could not be "other property" in a transaction qualifying as a "B" or "C" reorganization. While those definitions do literally require that "solely . . . voting stock" be given, that requirement raises questions of interpretation (not involved in this case) that have not yet been finally resolved. For example, since § 112(g)(1)(B) requires only that 80% of the stock of another corporation be acquired, it is arguable that that definition is met if the consideration allocable to at least 80% of the stock consists of voting stock, notwithstanding that the acquiring corporation also acquires additional shares

16 238 F.2d at 948.

17 368 U.S. 337 (1961), *aff'g* 286 F.2d 699 (9th Cir. 1960).

18 In Lutkins v. United States, 312 F.2d 803 (Ct. Cl.), *cert. denied*, 375 U.S. 825 (1963), 65.375 percent of *S* Corporation's stock was acquired by *P* Corporation in 1912 solely for voting stock; in the period 1929-1953, 2.69 percent was acquired for cash; and in 1952, 29.49 percent was acquired solely for voting stock. The Commissioner argued that there was no "B" reorganization unless *P* Corporation acquired 80 percent "control" of *S* Corporation in one transaction solely for its voting stock. The Court of Claims held that there was no "B" reorganization in 1952 because (a) the 1952 transaction did not involve the acquisition of 80 percent of *S* Corporation's stock, and (b) the cash transactions prior to 1952 had to be taken into account. Judge Whitaker, dissenting, was of the opinion that 80 percent "control" was acquired solely for voting stock, and that "the acquisition for cash of the small percentage of 2.69 percent, being wholly unrelated to the plan of reorganization, is to be disregarded." 312 F.2d at 807. It would appear, however, that the dissenting judge distinguished *Howard* on the facts, neither accepting nor rejecting its legal conclusion.

> (e.g., from dissenting stockholders) for money or other property. That was in fact the situation in the *Howard* case, in which the acquiring corporation gave solely voting stock for 81% of the shares but gave cash to a dissenting minority for the remaining 19%. While the Seventh Circuit held that the cash given the minority precluded a "B" reorganization, the question is a debatable one and there is no assurance that other courts would follow that decision.[19]

Not only is there no assurance that other courts will follow the *Howard* decision under the 1939 Code, but tax commentators are of the view that *Howard* was incorrectly decided, that in any event there is no need to follow it under the 1954 *Code*, and that eventually the "B" reorganization definition will be held to be met if the consideration allocable to at least 80 percent of the acquired corporation's stock consists solely of voting stock of the acquiring corporation, notwithstanding that the acquiring corporation also acquires additional shares for money or other property.[20] If the Treasury is not willing to amend its regulations or its tax ruling policy to accord with this view, it should sponsor or support legislation which would clarify the applicable rule.

It is not likely, however, that the Treasury Department will readily abandon its present interpretation of the "B" reorganization definition. Even in the case of an obviously incorrect statement in the reorganization regulations it has failed to make an appropriate modification. Some years ago, when the proposed regulations under the 1954 *Code* were under consideration, I commented[21] on the desirability of modifying the longstanding regulations' requirement that "[t]he plan of reorganization must be adopted by each of the corporations parties thereto . . . ."[22] to make clear that the requirement does not apply to "B" reorganizations. Such a modification is necessary because the regulations also provide that both the acquiring and the acquired corporation in a "B" reorganization are each a party to the reorganization.[23]

The fact of the matter is that in the case of many a tender offer,

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19 Brief for Respondent at 21 n.7, Turnbow v. Commissioner, 368 U.S. 337 (1961).

20 *See* Merritt, *supra* note 2, at 926-36; Rosenzweig, *supra* note 13, at 1019; Vernava, *supra* note 1, at 404-09. *See also* articles cited in Kanter, *supra* note 1, at 454 n.37.

21 *See* Merritt, *supra* note 2, at 925-27.

22 Treas. Reg. § 1.368-3(a) (1955). The provisions of this section were originally included in Reg. 86, art. 112(g)-6(a), interpreting the Revenue Act of 1934.

23 Treas. Reg. § 1.368-2(f) (1955). Note that a corporate party to a reorganization *agreement* is not necessarily a party to a *reorganization.* Groman v. Commissioner, 302 U.S. 82 (1937); *See* R. PAUL, STUDIES IN FEDERAL TAXATION 106-08 (3d Series 1940).

the board of directors of the corporation whose stock is sought to be acquired by the would-be acquiring corporation, not only does not take affirmative action to adopt a plan of reorganization, but the board is often strenuously opposed to the "take over." The situation is described in a recent article:[24]

> Under the typical state corporation law the board of directors is necessarily involved in any transaction of merger or sale of assets. The transaction involves a corporate act, carried out ultimately by the stockholders' exercise of their voting power but in the first instance depending upon favorable action of the board. At both board and stockholder levels, approval by the requisite majority is binding upon the entire body, but the stockholders never get a chance to accept or reject unless the board first acts favorably.
>
> In theory at least, none of this is true of the normal tender offer. In the center of things stands T Company, with its existing management and its presently outstanding securities. The owners of the stock are addressed as a group, through a letter or advertisement, but they are asked merely to make individual decisions to sell to A; and resulting transactions are between sellers and a buyer of outstanding stock, not corporate transactions at all.[25]

While the foregoing remarks are addressed to tender offers for cash, they are equally appropriate to tender offers solely for voting stock[26] of the offeror. Clearly, in view of the realities of tender offers, the regulations should be amended because they go too far, and their continued presence represents an unnecessary and unwarranted threat of possible future conflict.

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[24] Cohen, *Tender Offers and Takeover Bids*, 23 BUS. LAW. 611 (1968).

[25] *Id.* at 616-17.

[26] Quaere whether a voting preferred stock which by its terms is convertible into voting common stock constitutes *solely* voting stock. Is the conversion privilege "boot"? In view of recent discussion of whether convertible debentures may be deemed to have an original issue discount feature because of the value of the conversion right (*see* 28 J. TAXATION 142 (1968)), this could be a question of developing importance. *See* Proposed Treas. Reg. § 1.1232-3(b)(2)(i), 29 Fed. Reg. 12,078 (1964), which states that "[i]n the case of an obligation which is convertible into stock or another obligation, the issue price includes any amount paid in respect of the conversion privilege." *Compare* 28 J. TAXATION 142 (1968), *with* T.M.M. 68-1, 10 (Jan. 1, 1968), discussing the Service's alleged views on whether voting stock of an acquiring corporation which is convertible into the voting stock of the acquiring corporation's parent, can be given in a "B" or "C" reorganization.