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C Reorganizations–Exchange of Stock for Assets

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I. INTRODUCTION

THE "C" REORGANIZATION, in practical effect, is a merger. However, it may be less flexible than a merger both in terms of the extent to which the properties to be transferred may be selected and in terms of the choice of consideration used to effect the acquisition. The situations in which a "C" reorganization may be employed are numerous and varied. One of these is where the State statutory conditions to a merger cannot be satisfied.[1]

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A. *Essential Elements of a "C" Reorganization*

A "C" reorganization is specifically described and defined in the *Internal Revenue Code.*[2] It is the acquisition by one corporation of substantially all of the properties of another corporation. At least 80 percent of the properties must be acquired in exchange solely for voting stock of the acquiring corporation. The acquisition may be effected either with voting stock of the acquiring corporation or voting stock of a corporation which controls the acquiring corporation. The acquisition must be by a single corporation; therefore, the acquisition cannot be partly for stock of a parent corporation and partly for stock of its subsidiary.[3] However, by express statutory provision, the properties acquired by the acquiring corporation may be *divided* between the parent and its controlled subsidiaries.[4] In determining whether the exchange is solely

[1] Since a merger must qualify as such under State or federal statutes to be a tax-free "statutory merger," mergers involving foreign corporations generally cannot constitute "A" reorganizations. Moreover, amalgamations of certain special types of corporations may not be permitted under the pertinent local merger statutes. In such situations, a "C" (or "D") reorganization may be the only way to accomplish the transaction on a tax-free basis.

[2] INT. REV. CODE OF 1954, § 368(a)(1)(C) [hereinafter cited as CODE].

[3] Treas. Reg. § 1.368-2(d)(1) (1955).

[4] CODE § 368(a)(2)(C).

for voting stock, those liabilities of the acquired corporation are disregarded which are assumed by the acquiring corporation (or to which the acquired property is subject) as part of the transaction.[5] The statute expressly provides that if the transaction would qualify as both a "C" reorganization and a "D" reorganization, the fact that it qualifies as a "D" reorganization prevents it from qualifying as a "C" reorganization.[6]

B. *The "C" Reorganization as a De Facto or Nonstatutory Merger*

The "C" reorganization has been referred to as a practical merger.[7] Indeed, some statutory mergers may also qualify for tax purposes as "C" reorganizations.[8] From an income tax point of view, more conditions must be satisfied in order for a transaction to qualify as a tax-free "C" reorganization than in the case of a statutory merger or "A" reorganization. However, the statutory requirements for mergers under State or federal law often impose conditions or procedural requirements which are not present in a "C" reorganization.

One of the advantages of a merger over a "C" reorganization is that once the statutory provisions of State or federal law for the merger have been satisfied, the transaction will usually qualify as a tax-free reorganization. This results in more leeway in the particular terms and conditions of the merger, including the consideration exchanged, which may not be available as options in a "C" reorganization.

C. *Optional Features of a "C" Reorganization.*

The essential elements of a "C" reorganization have been outlined above. In addition, there are optional elements or features of a "C" reorganization which (1) permit consideration other than voting stock to be used in effecting the acquisition, (2) permit the acquisition of assets by other than the corporation issuing the

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[5] The regulations provide that the assumption of liabilities "may in some cases . . . alter the character of the transaction" so as to place it "outside the purposes and assumptions of the reorganization provisions." Treas. Reg. § 1.368-2(d)(1) (1955). This enigmatic language raises a troublesome question as to when the assumption of liabilities will so alter the general character of the transaction as to cause a transaction otherwise qualifying as a "C" reorganization to become disqualified. *See also* text accompanying notes 30-31 *infra.*

[6] CODE § 368(a)(2)(A); Treas. Reg. § 1.368-2(d)(3) (1955).

[7] Rev. Rul. 56-345, 1956-2 CUM. BULL. 206.

[8] Rev. Rul. 67-326, 1967 INT. REV. BULL. No. 40, at 12.

voting stock, and (3) permit the acquired corporation to remain in existence after the reorganization exchange of its properties for the voting stock of the acquiring corporation.

(1) Use of Consideration in Addition to Voting Stock. —This first optional element permits the *limited* use of money or other property to effect the acquisition.[9] However, this option is available only where at least 80 percent, in terms of fair market value, of the properties of the acquired corporation are acquired solely for voting stock of the acquiring corporation.

There is an important limitation upon the application of this optional feature — the assumed liabilities of the acquired company, and the liabilities to which the acquired properties are subject, are treated as money for purposes of determining whether the 80 percent criterion is met.

The following examples, taken from the Treasury regulations,[10] show how this optional feature applies:

	Example 1	*Example 2*
Acquired corporation:		
properties worth	\$100,000	\$100,000
liabilities	10,000	50,000
Acquiring corporation:		
exchanges its voting stock worth	82,000	50,000
assumes liabilities of	10,000	50,000
pays cash of	8,000	-0-

In Example 1, since more than 80 percent of the properties of the acquired corporation are acquired for voting stock, the terms of the statutory exception which permits consideration in addition to voting stock are satisfied. In other words, the cash payment of \$8,000 is permitted in Example 1 without destroying the "C" reorganization because, when the \$8,000 is added to the liabilities of \$10,000, the fair market value of the properties acquired solely for voting stock is more than 80 percent of the total value of the acquired corporation's properties.

However, in Example 2, no consideration other than voting stock would be permitted since the assumption of liabilities (which may be disregarded if the only consideration is voting stock), would have the effect of causing the acquisition of less than 80 percent of the properties to be solely for voting stock when such liabilities are considered.

(2) Use of Controlled Subsidiaries To Acquire the Properties.

[9] CODE § 368(a)(2)(B).

[10] Treas. Reg. § 1.368-2(d)(3) (1955).

—The second optional feature in a "C" reorganization permits the transfer of all or part of the properties of the acquired corporation directly to one or more subsidiaries controlled by the corporation issuing its voting stock to the acquired corporation.[11] This is a desirable, flexible feature of the "C" reorganization which permits casting the transaction in such a way as to be in accord with the business and economic realities of the situation.

It should be noted that this flexible feature of a "C" reorganization may not be permitted in a statutory merger or "A" reorganization. Thus, it has been ruled that the merger of an acquired corporation into a subsidiary of the acquiring corporation in exchange for the acquiring corporation's stock is not a tax-free "A" reorganization, since the parent is not a party to the reorganization.[12] Interestingly, in the same ruling it was indicated that the transaction would probably qualify as a tax-free "C" reorganization.

(3) Continuation of the Acquired Corporation. —A third feature, not present in a merger reorganization, is the option not to liquidate the acquired corporation but to continue it in existence.[13] While there may be business or investment advantages in retaining the acquired corporation as a viable entity after the transaction is completed, there are at least two possible disadvantages where the voting stock received in the transaction is not promptly distributed to the acquired corporation's shareholders. First, a later distribution of the voting stock to the acquired corporation's shareholders will not be tax-free as to them if it is not made pursuant to the reorganization plan.[14] Second, carryover to and use by the acquiring corporation of any net operating losses of the acquired corporation, which otherwise would be available, will be barred.[15]

II. WHEN HAVE "SUBSTANTIALLY ALL" OF THE PROPERTIES BEEN ACQUIRED?

One of the more difficult questions which arises in planning a

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[11] CODE § 368(a)(2)(C).

[12] Rev. Rul. 67-326, 1967 INT. REV. BULL. NO. 40, at 12. This obstacle to an "A" reorganization can probably be avoided by merging the acquired corporation into the parent corporation in exchange for stock of the parent corporation and then distributing part or all of the acquired assets to a controlled subsidiary of the parent corporation.

[13] Unlike situations involving an "A" or "D" reorganization, neither the statute nor the regulations require the liquidation of the acquired corporation in a "C" reorganization.

[14] Treas. Reg. § 1.354-1(a) (1955).

[15] *Id.* § 1.382(b)-1(a)(2) (1962).

"C" reorganization is the one of determining whether the transaction involves the acquisition of "substantially all" the properties of the acquired corporation.[16] This problem is not unique to "C" reorganizations. In fact, the "substantially all" test arises elsewhere in the *Internal Revenue Code*, including Subchapter C. Thus, in a "D" reorganization, "substantially all of the assets" of the transferor corporation must be acquired by the acquiring corporation.[17] Essentially this requirement, common to both "C" and "D" reorganizations, is tested by the same standards.

A. *Quantitative Aspects of Test*

It is helpful to outline a few of the operating rules or general principles which are relevant in applying the "substantially all" test. The test is applied in terms of market values.[18] Moreover, the value of intangibles, whether or not they are reflected on the books, must also be included in the value of the properties to which the test is applied.[19] From this it follows that the book value of properties generally will be immaterial except insofar as they may be relevant in determining fair market value.

Preliminarily, it should be noted that application of the "substantially all" test often presents difficult valuation questions. Thus it may be desirable to consider the sale of unwanted assets to establish their value in order to determine whether the "substantially all" test has been satisfied. However, a note of caution must be made since the sale of unwanted assets to establish their value may also have the effect of causing less than "substantially all" of the properties to be transferred; it also could result in denial of tax-free status to the transaction on the ground that the "continuity of business enterprise" requirement has not been satisfied.

B. *Qualitative Aspects of Test*

There is a growing body of judicial and administrative authority suggesting that the "substantially all" test is to be applied only to the corporation's operating assets. Thus, in a recent ruling, a corporation whose assets were acquired retained cash, notes receivable, accounts receivable, and 3 percent of its inventory, the aggregate value of the retained assets being approximately equal to the

[16] *Id.* §§ 1.368-2(d)(1), (2).

[17] CODE § 354(b)(1)(A).

[18] Schuh Trading Co. v. Commissioner, 95 F.2d 404 (7th Cir. 1938).

[19] *Id.* at 410.

corporation's liabilities. The Commissioner ruled that the transfer of the remaining properties to the acquiring corporation in exchange for its voting stock satisfied the "substantially all" requirement of a "C" reorganization.[20] However, there is authority to the contrary. For example, where all of the operating assets of a corporation (68 percent of the total properties in terms of value) were transferred and only accounts receivable were retained, the Ninth Circuit held that the test had not been met.[21]

Certain generalizations may be made as to the factors which are relevant in determining whether the "substantially all" test has been satisfied. These factors include the nature of the properties retained by the acquired corporation, the purpose of the retention of the properties, and the value of the properties retained as compared with the total value of the properties available for acquisition.[22]

The test applied in a "C" reorganization is in terms of *properties* whereas the test applied in a "D" reorganization is in terms of *assets*. There is some authority for the proposition that the word "property" connotes a broader concept than that of "assets." Thus, property is said to mean assets plus working capital (including cash) useful in the business.[23] However, it is not clear that distinctions such as this will be applied in the area of "C" reorganizations.

A practical problem may arise in connection with the possible retention by the acquired corporation or its shareholders of property which is leased to the acquiring corporation as an incident to a "C" reorganization. The cases suggest that a long term lease to the acquiring corporation may constitute a transfer of property for purposes of the "C" reorganization,[24] and, conversely, that a short term lease will not satisfy the "substantially all" requirement.[25]

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[20] Rev. Rul. 57-518, 1957-2 CUM. BULL. 253; *accord*, Moffatt v. Commissioner, 363 F.2d 262 (9th Cir. 1966), *cert. denied*, 386 U.S. 1016 (1967); Commissioner v. First Nat'l Bank, 104 F.2d 865 (3d Cir. 1939); Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937); Western Indus. Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936); Nelson v. United States, 69 F. Supp. 336 (Ct. Cl. 1947), *cert. denied*, 331 U.S. 846 (1948); Daily Tel. Co., 34 B.T.A. 101 (1936).

[21] Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1937).

[22] Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

[23] Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937).

[24] R & J Furniture Co., 20 T.C. 857, 865-66 (1953), *acquiesced in*, 1954-1 CUM. BULL. 6, *rev'd on other grounds*, 221 F.2d 795 (6th Cir. 1955) (55 years, or longer than useful life).

[25] Daniels Buick, Inc. v. Commissioner, 251 F.2d 528 (6th Cir. 1958) (5-year renewable lease with option of first refusal).

Another way of approaching the question of whether "substantially all" of the properties have been acquired in a "C" reorganization is to determine whether gross assets, net assets, or both are to be considered in applying the test.[26] The Internal Revenue Service has recognized that the gross asset and net asset concepts are helpful in applying the "C" reorganization provisions. Thus, the Service has indicated that it will rule favorably in a "C" reorganization if, in terms of fair market value of the property immediately prior to the acquisition, at least 90 percent of the net assets and at least 70 percent of the gross assets are transferred.[27] In an earlier ruling, it had been held that the "substantially all" test had been satisfied where 70 percent in value of the gross properties were transferred and the properties not transferred were approximately equal in value to the amount of the liabilities of the corporation whose properties were being acquired.[28]

Generally, the problems in this area can be avoided by having the acquiring corporation satisfy the acquired corporation's liabilities after the acquisition has been completed. However, care must be exercised here in handling liabilities arising out of the transaction itself, such as the right of dissenting shareholders to receive the cash value of their shares. Such liabilities cannot be assumed by the acquiring corporation, but must be paid by the acquired corporation in order to avoid disqualification under the "solely for voting stock" requirement of a "C" reorganization.[29]

One further point deserves mention here. Previously it was observed that the regulations provide that a transaction involving an assumption of liabilities may so alter the character of the transaction as to place it outside the purposes and assumptions of the reorganization provisions.[30] This means that in a situation where the liabilities of the acquired corporation are very large in relation to the value of its gross properties, the assumption of the liabilities by the acquiring corporation (or even the satisfaction of the liabilities by the acquired corporation from its own assets) may prevent the transaction from qualifying as a "C" reorganization, although it technically satisfies the requirements.[31]

[26] *See* Milton Smith, 34 B.T.A. 702 (1936), *acquiesced in*, 1957-2 CUM. BULL. 6.

[27] Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232.

[28] Rev. Rul. 57-518, 1957-2 CUM. BULL. 253.

[29] This requirement is discussed at text accompanying notes 9-10 *supra*.

[30] *See* note 5 *supra*.

[31] *See* Milton Smith, 34 B.T.A. 702 (1936). Further doubt as to the meaning of this enigmatic language in the regulations is raised by a recent decision of the Tax

C. *When the Test is To Be Applied*

No consideration of the problems which arise in determining whether the "substantially all" test has been satisfied would be complete without consideration of the problem of *when* the test is to be applied. For purposes of analysis, properties may be disposed of or acquired before a "C" reorganization, during the reorganization, or after the reorganization.

Property of the corporation whose properties are being acquired in the "C" reorganization may be distributed, prior to the reorganization in the following ways: by a stock redemption or dividend, by a partial liquidation, by a sale of property to a related or unrelated party, or by a tax-free spin-off or the like. In such situations, the fact that nonoperating assets are distributed prior to the reorganization, or that the prereorganization distribution is taxed to the recipients as a dividend rather than at capital gain rates, may be relevant.[32] Generally, it must be assumed for planning purposes that a distribution prior to the reorganization will be treated by the Internal Revenue Service as a part of the reorganization plan under the "step-transaction" doctrine. If so, the question remains as to whether the "substantially all" requirement is met and, if so, whether the distribution may result in taxable boot to the shareholders of the corporation whose properties are being acquired.

In an interesting case, reaching a questionable conclusion, the Tax Court held that the prior spin-off of 34 percent of the acquired corporation's properties, which were not wanted by the acquiring corporation, followed by the transfer of the remaining 66 percent of the acquired corporation's properties in exchange for the acquiring corporation's voting stock, constituted a tax-free "C" reorganization.[33] The Commissioner's nonacquiescence in the decision indicates that this authority may not safely be used for planning purposes.

When property of the acquired corporation is distributed in the course of a reorganization or under the plan of reorganization, the effect at the shareholder level is tested by the boot provisions of

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Court, Norman Scott, Inc., 48 T.C. 598 (1967), which held that a tax-free merger occurred where debenture holders of an insolvent corporation received stock in the acquiring corporation and where the shareholders of the insolvent corporation received nothing.

[32] *See* Gross v. Commissioner, 88 F.2d 567 (5th Cir. 1937); Thurber v. Commissioner, 84 F.2d 815 (1st Cir. 1936).

[33] Richard K. Mellon, 12 T.C. 90, 108-109 (1949), *nonacquiesced in*, 1949-2 CUM. BULL. 4, *aff'd on other grounds*, 184 F.2d 157 (3d Cir. 1950).

the *Internal Revenue Code*.[34] Such a distribution may also be relevant in determining whether the "substantially all" requirement of a "C" reorganization has been satisfied.

Where the acquired corporation has contingent liabilities or owns property rights whose values are contingent upon future events, a question may arise as to whether substantially all of the properties have been acquired by the acquiring corporation. In one case, it was held that the "substantially all" test is to be applied after the expiration of the contingencies, such as the running of the time for the assertion of guarantees affecting the amount of the acquired corporation's liabilities.[35]

III. THE ACQUIRING CORPORATION

As has been noted above, a "C" reorganization may be effected by the transfer of the properties of the acquired corporation to a controlled subsidiary of the corporation whose voting stock is issued in the reorganization exchange.[36] Generally, this is done by having the parent of the acquiring corporation transfer its voting stock to its controlled subsidiary (the acquiring corporation) which then receives the properties of the acquired corporation in exchange for the parent corporation's voting stock.[37]

A corporation may agree to acquire properties of another corporation in exchange for voting stock and then cause the properties to be transferred directly to one or more subsidiaries controlled by the acquiring corporation or to controlled subsidiaries of such subsidiaries.[38]

Selection of the one or more controlled corporations which will ultimately acquire the properties of the acquired corporation may be important. Careful planning may permit the utilization of cer-

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[34] CODE § 356.

[35] Schuh Trading Co. v. Commissioner, 95 F.2d 404 (7th Cir. 1938).

[36] CODE § 368(c) defines "control" as ownership of stock carrying at least 80 percent of the total combined voting power of all classes of voting stock and at least 80 percent of the total number of shares of all other classes of stock of the corporation. *But cf.* Rev. Rul. 59-259, 1959-2 CUM. BULL. 115, holding, apparently contrary to the plain terms of section 368(c), that at least 80 percent of *each class* of nonvoting stock must be owned. The definition of section 368(c) is more stringent than the statutory standard for filing consolidated income tax returns, where at least 80 percent of each class of nonvoting stock must be owned, but nonvoting stock which is limited and preferred as to dividends is disregarded. CODE § 1504(a). For the significance of voting power and number of shares (as distinguished from value) as the standard to be applied, see United States v. Parker, 376 F.2d 402 (5th Cir. 1967).

[37] Rev. Rul. 67-326, 1967 INT. REV. BULL. NO. 40, at 12.

[38] Rev. Rul. 64-73, 1964-1 (Part 1) CUM. BULL. 142.

tain tax advantages which otherwise might be entirely lost to the acquiring corporation. For example, the regulations provide that certain attributes of the acquired corporation, including net operating losses, carry over to the "acquiring" corporation, as specifically defined in the regulations.[39]

A. Consideration Exchanged in the Acquisition

The consideration which the acquiring corporation may use to effect the acquisition in a "C" reorganization is limited either to its voting stock or to the voting stock of its parent corporation provided the parent corporation owns at least 80 percent of the voting power and 80 percent in terms of value of all other classes of stock of the subsidiary.[40]

(1) Solely for Voting Stock. —The definition of a "C" reorganization requires that the acquiring corporation acquire at least 80 percent of the total properties being acquired in exchange "solely for . . . [its] voting stock." This language is identical to the analogous definition of a "B" reorganization, involving the tax-free acquisition of stock for stock.[41] The meaning of this elusive phrase has been interpreted both administratively and judicially. However, satisfaction of this requirement is often one of the more difficult problems in a transaction cast as either a "B" or a "C" reorganization.

The problem arises not so much with the difficulty of determining what is voting stock, but rather from the use of the absolute adverb "solely" as a modifier. As might be expected, this word leaves no room for the use of any other consideration by the acquiring corporation. The Supreme Court has interpreted and applied the phrase in accordance with its plain meaning.[42]

(2) Voting Stock. —The word "stock" is defined in the *Internal Revenue Code* to include shares in an association, joint stock company, or insurance company.[43] However, nowhere in the *Code* is the phrase "voting stock" defined. It is thus necessary to look

39 Treas. Reg. § 1.381(a)-1(b)(2) (1960).

40 For a discussion see note 36 *supra.*

41 *See generally* Merritt, *"B" Reorganizations and the "Solely" for Voting Stock Problem*, 19 CASE W. RES. L. REV. 990 (1968).

42 Turnbow v. Commissioner, 368 U.S. 337 (1961); Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

43 CODE § 7701(a)(7); *id.* §§ 7701(a)(3), (8) define the terms "corporation" and "shareholder." All three of these statutory definitions are broad rather than narrow, for they state what each term "includes," and they do not "exclude other things otherwise within the meaning of the term defined." *Id.* § 7701(b).

to the case law and administrative interpretations for a further understanding of this phrase.

At the outset, it can be emphasized that the authorities affirm that the concept of stock is broad and embraces most present ownership interests.[44] Thus, it has been held that ownership interests in an association, whose members have capital accounts and vote on a per capita rather than a per share basis, are stock interests.[45] Likewise, the ownership interest (*e.g.*, a voting share savings account) in a mutual building and loan association has been held to constitute a stock interest.[46]

The holders of preferred stock, having the right to significant participation in the management of a corporation's affairs, are considered to hold voting stock for purposes of the reorganization provisions.[47] Apparently any stock which participates in the election of directors is voting stock for purposes of the *Internal Revenue Code*. Restrictions or limitations on the voting power, such as the restriction of the voting power to election of a separate class of directors or a limitation on the number of votes per shareholder, will not cause the equity interests to fail to qualify as voting stock.[48] The important requirement is that the owner of the equity interest have the right to a significant participation in the management of the enterprise.

Certain equity interests have been held not to constitute stock. Included among these interests would be stock purchase warrants and securities convertible into stock.[49] Moreover, if the right to participate in the management of the enterprise arises from a contract separate from the equity interest itself, the ownership interest will not constitute voting stock.[50]

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44 The stock interest is not voting stock where the voting rights are contingent upon an event which has not occurred. However, where the contingency (*e.g.*, default in dividends) has happened, the stock is voting stock. I.T. 3896, 1948-1 CUM. BULL. 72. Placing the stock in a voting trust as part of the reorganization plan will not necessarily disqualify it as "voting stock." Peabody Hotel Co., 7 T.C. 600, 617 (1946), *acquiesced in*, 1946-2 CUM. BULL. 4.

45 Harry F. Cornwall, 48 T.C. 736 (1967).

46 Estate of W.T. Hales, 40 B.T.A. 1245 (1939), *acquiesced in*, 1940-1 CUM. BULL. 2, *nonacquiesced in*, 1940-1 CUM. BULL. 7. Associations and trusts taxable as corporations may be parties to a tax-free reorganization. Real Estate Investment Trust of America, 40 T.C. 921, 923 (1963); Rev. Rul. 67-376, 1967 INT. REV. BULL. NO. 44, at 13.

47 Rev. Rul. 63-234, 1963-2 CUM. BULL. 148.

48 I.T. 3896, 1948-1 CUM. BULL. 72.

49 Rev. Rul. 64-251, 1964-2 CUM. BULL. 338; Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

50 Rev. Rul. 66-339, 1966-2 CUM. BULL. 274, 276; Rev. Rul. 67-269, 1967 INT. REV. BULL. NO. 34, at 20.

(3) Contingent Stock. —Difficult questions have arisen where the amount of the voting stock to be issued by the acquiring corporation is uncertain at the time of the reorganization exchange because the amount is made to depend, as is not uncommon, upon future events. Typical of such a situation would be the current issuance of voting stock in a reorganization exchange together with a contractual commitment on the part of the acquiring corporation to issue additional shares if the business of the acquired corporation exceeds a certain specified amount in sales or net income over a given number of years.

The cases have generally permitted such contingent stock arrangements without destroying the tax-free nature of the reorganization exchange, either where the additional shares of the acquiring corporation are placed in escrow in exchange for shares of beneficial ownership,[51] or where certificates of contingent interest are issued by the acquiring corporation,[52] with the additional shares to be issued in the future as certain events come to pass. However, the Internal Revenue Service has cautiously limited its approval of these court decisions.[53]

In this respect, the Internal Revenue Service has recently issued a revenue procedure[54] to the effect that it will issue rulings in "B" and "C" reorganizations that the "solely for voting stock" requirement has been satisfied if the following conditions are met: (1) all the additional stock must be issued within 5 years of the reorganization exchange; (2) valid business reasons exist (*e.g.*, valuation problems) for not issuing all of the additional stock immediately; (3) the maximum number of shares which may be issued in the exchange is stated; (4) at least 50 percent of the maximum number of shares of each class which may ultimately be issued are issued in the initial distribution; (5) the agreement evidencing the right to receive the additional stock either prohibits its assignment (except by operation of law) or the right must not be evidenced by negotiable certificates and must not be readily marketable; and (6) such right can give rise to receipt of additional stock only.

Thus, by recent administrative action, the Commissioner has finally indicated a willingness, for ruling purposes, to permit the

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51 Philip W. McAbee, 5 T.C. 1130 (1945), *acquiesced in*, 1946-2 CUM. BULL. 4.

52 Carlberg v. United States, 281 F.2d 507 (8th Cir. 1960); James C. Hamrick, 43 T.C. 21 (1964), *acquiesced in result only*, 1966-1 CUM. BULL. 2.

53 Rev. Rul. 66-112, 1966-1 CUM. BULL. 68.

54 Rev. Proc. 67-13, 1967-1 CUM. BULL. 590, *amplifying* Rev. Proc. 66-34, § 3.03, 1966-2 CUM. BULL. 1232, 1233-34.

use of so-called "contingent" stock under very limited circumstances. This is indeed a constructive development and it may be hoped that the restrictions and limitations imposed by the Commissioner in this recent revenue procedure will be relaxed further in the future to permit more flexible planning in the "B" and "C" reorganization areas.

(4) The "Solely" Requirement. —Perhaps the most troublesome requirement in "B" and "C" reorganizations is the use of the word "solely" in the statute. The difficulty which this word can cause to the tax planner is difficult to overstate, as almost any undertaking by the acquiring corporation could be construed to be consideration in addition to voting stock.

For example, until very recently, the payment of cash in lieu of fractional shares, a common situation dictated in many reorganizations by business considerations, was held to violate the "solely" requirement.[55] Fortunately, in a recent ruling,[56] the Commissioner took the position that the mere payment of cash for fractional shares, if such payment was not separately bargained for, does not violate the "solely" requirement.

There are many other examples of commitments on the part of the acquiring corporation which must be considered in determining whether the acquisition is being made solely for voting stock. Some of these commitments include: an undertaking by the acquiring corporation to register the stock issued in the reorganization exchange upon certain contingencies or upon the request of the shareholders of the acquired corporation;[57] an agreement (whether part of the reorganization agreement itself or ancillary) on the part of the acquiring corporation to make payments to shareholders of the acquired corporation who may become employees of the acquiring corporation, such as consulting fees or payments for covenants not to compete; an undertaking on the part of the acquiring corporation to cause shareholder guarantees of obligations of the acquired corporation to be released; a commitment by the acquiring corporation or one or more of its shareholders to buy back the stock of the acquiring corporation from the shareholders of the acquired corporation;[58] the payment of expenses of the ac-

[55] *E.g.*, Richard M. Mills, 39 T.C. 393 (1962), *rev'd*, 331 F.2d 321 (5th Cir. 1964).

[56] Rev. Rul. 66-365, 1966-2 CUM. BULL. 116. Scrip certificates, exchangeable for full shares, may be issued in lieu of fractional shares. Rev. Rul. 55-59, 1955-1 CUM. BULL. 35.

[57] Rev. Rul. 67-275, 1967 INT. REV. BULL. NO. 35, at 11.

[58] Commissioner v. Harris, 92 F.2d 374 (3d Cir. 1937); Fifth Avenue Bank, 31

quired corporation or of its shareholders arising out of the reorganization; and warranties or guarantees of the financial statement and condition of the acquiring corporation.

The Commissioner does take the position, however, that the imputing of interest under section 483 will not violate the "solely" for voting stock requirement so as to prevent an otherwise eligible reorganization from qualifying as such.[59]

(5) Assumptions of Liabilities. —Difficult questions may also arise in determining the effect on a transaction of the assumption by the acquiring corporation of the acquired corporation's liabilities, or the taking of properties subject to such liabilities. As has previously been indicated, such handling of the liabilities normally does not affect the tax-free nature of a "C" reorganization if there is no consideration other than voting stock issued by the acquiring corporation. However, one caveat is necessary — the magnitude of the liabilities involved must not be so large as to make the transaction essentially a purchase instead of a reorganization.[60]

The action of the acquiring corporation in dealing with the acquired corporation's liabilities should not be more than a mere assumption of the liabilities. Thus, if new liabilities arise out of the reorganization, such as those of the shareholders of the acquired corporation, and such liabilities are assumed by the acquiring corporation, the tax-free nature of the reorganization may be destroyed.[61] While it may be permissible for the acquired corporation to retain cash or other assets sufficient to satisfy its liabilities, including those of its dissenting shareholders,[62] it is quite a different thing for the acquiring corporation to assume and pay such liabilities.[63] This means that care must be taken to make sure that nothing is done by the acquiring corporation which could be construed as an undertaking on its part to pay those liabilities which arise out of the transaction, as distinguished from those liabilities of the acquired corporation which existed prior to the transaction.

Another area where difficult questions have arisen is where the

B.T.A. 945 (1934), *nonacquiesced in*, XIV-2 CUM. BULL. 30, *aff'd*, 84 F.2d 787 (3d Cir. 1936); Daisy M. Ward, 29 B.T.A. 1251 (1934), *nonacquiesced in*, XIII-1 CUM. BULL. 31, *aff'd*, 79 F.2d 381 (8th Cir. 1935); *see* Walter B. Lashar, 34 B.T.A. 768 (1936), *nonacquiesced in*, 1937-1 CUM. BULL. 40.

59 Treas. Reg. § 1.483-2(a) (1967).

60 *But see* Norman J. Scott, Inc., 48 T.C. 598 (1967).

61 Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

62 Roosevelt Hotel Co., 13 T.C. 399 (1949), *acquiesced in*, 1950-1 CUM. BULL. 4.

63 *See* Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942). *But see* Roosevelt Hotel Co., 13 T.C. 399 (1949), *acquiesced in*, 1950-1 CUM. BULL. 4.

acquiring corporation alters in some respect the terms of the indebtedness of the acquired corporation. Thus, in one case the acquiring corporation substituted its bonds, having different maturity dates and interest rates and providing for payment of a portion of the interest out of earnings only. The court held that since there were no changes in the principal amount of the indebtedness, the act of the acquiring corporation in issuing its bonds in place of the acquired corporation's bonds did not exceed the mere assumption of liabilities for purposes of satisfying the requirements of a "B" reorganization.[64] By way of contrast, the opposite result was reached by the court in a situation where the acquiring corporation assumed the acquired corporation's unsecured liabilities by issuing new second mortgage bonds.[65] The court noted that the action of the acquiring corporation was more than a mere assumption since the acquiring corporation gave security for what had previously been an unsecured obligation.

If a problem arises because the parties want to have the acquiring corporation pay the acquired corporation's expenses of the reorganization (which payment would normally disqualify the transaction as a tax-free "C" reorganization), consideration should be given to having the acquiring corporation issue additional stock in an amount sufficient to cover the costs incurred in the transaction by the acquired corporation and its shareholders. Such additional stock consideration should not, of course, be earmarked for this purpose but it may properly be considered by the parties in negotiating the terms of the transaction. It is believed that attention in the course of negotiations to the amount of stock of the acquiring corporation which is to be issued in the exchange, in light of the values of the properties and the expenses being incurred by the acquired corporation and its shareholders, should not cause an otherwise tax-free "C" reorganization to become disqualified.

An alternative solution is to have the acquired corporation remain responsible for its liabilities. If this does not cause less than "substantially all" its properties to be transferred in the reorganization exchange, there should be no objection to planning the transaction in this way.[66]

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[64] New Jersey Mortgage & Title Co., 3 T.C. 1277 (1944), *acquiesced in*, 1945 CUM. BULL. 5.

[65] Stoddard v. Commissioner, 141 F.2d 76 (2d Cir. 1944).

[66] *See* notes 5 & 31 *supra*. For ruling purposes, the acquired corporation cannot retain more than 30 percent in value of its total properties for this purpose. Rev. Proc. 66-34, 1966-2 CUM. BULL. 1232.

Where the liabilities are so large that little stock of the acquiring corporation is issued or where the liabilities exceed the value of the properties acquired so that there is no equity in the properties being transferred, but stock of the acquiring corporation is issued in an attempt to qualify the transaction as a "C" reorganization, such an attempt will probably be unavailing.[67]

It is important to note that the exception which permits the liabilities to be disregarded requires that *all* properties, including the properties retained by the acquired corporation, must be considered in determining if 80 percent or more of the properties is being acquired for stock.[68] Care must be taken to account for the possibility not only of hidden or contingent liabilities but also of hidden or contingent properties. Thus, the parties could plan a transaction based upon the assumption that 80 percent of all the properties were being acquired for stock and on the further assumption that the nonstock consideration, such as cash and the liabilities assumed, was less than 20 percent of the total value of the properties; they might later find either that there were properties not appearing on the books (or contingent property rights) retained by the acquired corporation which ultimately prove to be of such a magnitude as to increase above 20 percent the total value of properties not being acquired. In short, the value of the assets of the acquired corporation and the amount of its liabilities must be carefully determined if the transaction is to come within the 20 percent tolerance for nonstock consideration. One possible way of solving this problem would be for the acquiring corporation to limit the extent of the liabilities for which it will be responsible (plus the nonstock consideration) to less than 20 percent of the fair market value of the acquired corporation's properties.

IV. THE NONSTATUTORY REQUIREMENTS FOR A TAX-FREE REORGANIZATION

There are certain additional requirements, applicable generally to most reorganizations, which should be mentioned although treatment of them is beyond the scope of this article. These include the doctrines of business purpose, continuity of business enterprise activity, continuity of ownership interest, step transactions, and the substance-versus-form analysis.

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67 Treas. Reg. § 1.368-2(d)(1); *cf.* Civic Center Fin. Co. v. Kuhl, 83 F. Supp. 251 (E.D. Wis. 1948), *aff'd per curiam*, 177 F.2d 706 (7th Cir. 1949).

68 Treas. Reg. § 1.368-2(d)(2)(ii) (1955).

V. SPECIAL SITUATIONS

There are several special situations which create unusual problems in seeking to plan a transaction as a "C" reorganization. The following are some of these special situations and an indication of the problems which may arise.

A. *A "B" Reorganization as Part of a "C" Reorganization*

A transaction may start out to be, and may in fact be carried out as, a "B" reorganization, *i.e.*, an acquisition of stock of the acquired corporation solely for voting stock of the acquiring corporation. Then, at a later date, it may be concluded that the acquired corporation should be liquidated or merged into the acquiring corporation. If the subsequent liquidation or merger can be said to have been part of the same plan pursuant to which the original "B" reorganization took place, then the entire transaction may be viewed as a single transaction and may constitute, or be tested for tax-free exchange purposes as, a "C" reorganization.

This shift in qualification standards may raise some difficult questions. For example, in an otherwise valid tax-free "B" reorganization, the acquired corporation may assume certain responsibilities of its shareholders, such as their liabilities incurred in the transaction, or the acquired corporation may itself have some outstanding liabilities which it incurred in connection with the transaction. In either case, the merger or liquidation of the acquired corporation into the acquiring corporation would result in the assumption of such liabilities by the acquiring corporation. Thus, if the transaction is tested as a "C" reorganization (rather than as a "B" reorganization), it may not qualify as a tax-free "C" reorganization because of the assumption by the acquiring corporation of liabilities incurred by the acquired corporation or its shareholders in connection with the reorganization transaction itself.[69]

Another problem may arise when a "B" reorganization is turned into a "C" reorganization if a stock redemption preceded the "B" reorganization. It has been ruled that a "B" reorganization is not invalidated where a relatively small amount of the stock of the acquired corporation is redeemed by the acquired corporation prior to the "B" reorganization exchange. While such a redemption will not invalidate a "B" reorganization, a serious question could arise

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[69] Rev. Rul. 67-274, 1967 INT. REV. BULL. NO. 35, at 10. *See also* Rev. Rul. 57-53, 1957-1 CUM. BULL. 291.

if the acquired corporation were found to have been liquidated or merged into the acquiring corporation as a part of the original "B" reorganization plan. As a result of such a merger or liquidation, the transaction might be tested under the "C" reorganization requirements and it could well be found that because of the redemption, substantially all of the properties of the acquired corporation were not acquired by the acquiring corporation. This would mean that what at the outset had been thought to be a valid "B" reorganization would now become a fully taxable transaction because of its failure to meet the tests of a "C" reorganization.

Yet a further possible problem could arise in the situation where the acquiring corporation owns stock in the acquired corporation prior to an otherwise valid "B" reorganization. Such a situation in practice could be fairly common for it is permissible for the acquiring corporation to own, indeed for it to have acquired by purchase, an interest in the acquired corporation prior to but not as a part of a "B" reorganization. If, at a later time, the acquired corporation is liquidated or merged into the acquiring corporation, and if the tax-free status of the transaction depends upon its meeting the "C" reorganization tests, it may be that the transaction will not qualify because the properties of the acquired corporation will not have been acquired *solely* for voting stock of the acquiring corporation.

B. Disposition of the Voting Stock After the Reorganization Exchange

A second major area of special situations and problems arises where the acquired corporation or its shareholders dispose of the acquiring corporation's voting stock issued in connection with the reorganization exchange. If the disposition of the acquiring corporation's shares is not pursuant to a preconceived plan, *i.e.*, if it is not part of the "C" reorganization plan, such disposition should not have any effect upon the transaction.[70] However, if the disposition is found to be part of such a plan, application of the step transaction doctrine may destroy the continuity of ownership interest requisite to all reorganizations.

Another problem may arise where part of the acquired corporation's properties are disposed of prior to the reorganization. This, of course, becomes relevant because of the "substantially all" requirement. Again, the question arises whether the prior disposition

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[70] Rev. Rul. 56-345, 1956-2 CUM. BULL. 206.

of the acquired corporation's properties is a part of the "C" reorganization plan. If so, then the magnitude and nature of the properties disposed of must not be such as to preclude the transaction from satisfying the "substantially all" test.

C. *Prior Ownership Interest of Acquiring Corporation in Acquired Corporation*

An unusual problem arises in the not uncommon situation where the acquiring corporation already owns part of the stock of the acquired corporation and then seeks to acquire all of the acquired corporation's property in exchange solely for voting stock of the acquiring corporation. The courts have held, somewhat surprisingly, that such a transaction does not qualify as a "C" reorganization where the acquired corporation is liquidated following the reorganization exchange.[71] The courts reason that the acquiring corporation is acquiring the acquired corporation's properties for (1) the acquiring corporation's voting stock plus (2) the surrender of the acquiring corporation's preexisting stock interest in the acquired corporation. Hence, the solely for voting stock requirement of a "C" reorganization has not been satisfied.

It is possible to avoid this result in one of several ways. First, the use of the 20 percent exception for other than voting stock may solve the problem although this is not promising if the acquired corporation has substantial liabilities. Another possible solution would be to avoid the liquidation of the acquired corporation. This, however, may not be practical or feasible. The problem can also be solved by having a subsidiary of the acquiring corporation, instead of the acquiring corporation itself, acquire the properties of the acquired corporation in exchange for the parent corporation's voting stock.[72]

Another possible solution, outside the "C" reorganization area, is to effect the transaction as a merger of the acquired corporation into the acquiring corporation, although even here the authorities are split as to whether the transaction will be tax free.[73] Yet another method is to carry out the planned "C" reorganization and

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[71] *See* Bausch & Lomb Optical Co. v. Commissioner, 267 F.2d 75 (2d Cir.), *cert. denied*, 361 U.S. 835 (1959); Grede Foundries, Inc. v. United States, 202 F. Supp. 263 (E.D. Wis. 1962).

[72] *See* Rev. Rul. 57-278, 1957-1 CUM. BULL. 124.

[73] *Compare* Gutbro Holding Co. v. Commissioner, 138 F.2d 16 (2d Cir. 1943), *with* Rogan v. Starr Piano Co., 139 F.2d 671 (9th Cir. 1943), *cert. denied*, 322 U.S. 728 (1944).

then follow it with a merger of the acquiring corporation into the acquired corporation instead of the liquidation of the acquired corporation.

VI. CONCLUSION

The provisions of section 368(a)(1)(C) have been analysed with particular attention to the problems which may be encountered. It may be helpful to summarize some of the advantages and disadvantages of this type of tax-free reorganization.

Some Advantages and Disadvantages of a "C" Reorganization[74]

1. Advantages:
   a. Facilitates avoiding inadvertent assumption of acquired corporation's hidden liabilities.
   b. May eliminate non-acquiescing minority shareholders of acquired corporation.
   c. May avoid dissenters' rights for acquiring corporation's shareholders. However, in Ohio, see OHIO REV. CODE §§ 1701.84(D), 1701.85 (Page 1964).
   d. Less stringent requirements of securities laws.
   e. Generally, acquiring corporation's shareholders need not authorize transaction, except for certain listed corporations and for authorization of any additional stock needed to effect acquisition. Rule may be contra in Ohio: OHIO REV. CODE § 1701.84 (Page 1964).
   f. Permissible limited use of consideration in addition to voting stock.
   g. Properties may be divided among acquiring corporation and its controlled subsidiaries.
2. Disadvantages:
   a. More cumbersome (*e.g.*, deeds, bills of sale, bulk sales law, etc.).
   b. Acquired corporation's identity may not be acquired.
   c. Acquired corporation's shareholders must authorize transaction.
   d. Dissenters' rights of acquired corporation's shareholders.
   e. Acquiring corporation's shareholders, in Ohio, may be required to authorize transaction and may have dissenters' rights.
   f. Compliance with restrictions in loan agreements and similar documents.

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[74] Pomeroy, *Stock for Assets — § 368(a)(1)(C)*, in LECTURE OUTLINES FOR THE TENTH ANNUAL CLEVELAND REGIONAL TAX INSTITUTE 125, 129 (1967).