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Income Tax--Gain on Stock for Stock Plus Boot Transaction--Fully Taxable

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INCOME TAX — GAIN ON STOCK FOR STOCK PLUS BOOT TRANSACTION — FULLY TAXABLE

Turnbow v. Commissioner, 368 U.S. 337 (1961)

Petitioner, sole stockholder of International Dairy Supply Company, transferred all the outstanding stock to Foremost Dairies, Incorporated, in exchange for voting stock of Foremost and cash. In his income tax return for 1952, petitioner reported a capital gain limited to the extent of the cash received.[1] The Commissioner determined that the entire gain was recognizable and assessed a deficiency On the taxpayer's petition for redetermination, the Tax Court reversed the finding of the Commissioner and held that the cash received was the only recognizable gain.[2] The Court of Appeals for the Ninth Circuit reversed that decision,[3] and on certiorari to the Supreme Court, the decision of the Court of Appeals was sustained,[4] thus settling a controversy between the Seventh and Ninth Circuit Courts of Appeals.[5] The Supreme Court ruled that the gain on an exchange of stock for stock plus "boot," (money or other property received in an otherwise non-taxable transaction), is fully taxable and not limited to the amount of "boot" received.

Generally, the entire gain or loss upon an exchange or sale of property is recognized at the time of the transaction.[6] However, no gain or loss is recognized when stock in one corporation is exchanged, pursuant to a plan of reorganization, solely for stock in another corporation.[7] The Internal Revenue Code provides six statutory definitions of the term "reorganization" as used in the non-recognition provision.[8] A "B" reorganization is the acquisition by one corporation of at least eighty per cent of the voting stock and at least eighty per cent of the total number of all other classes of stock of another corporation in exchange *solely* for all or a part of its voting stock.[9] A "C" reorganization is the acquisition by one corporation of substantially all the properties of another corporation in

1. Petitioner's basis in the stock transferred was $50,000 and his expenses in connection therewith were $21,933.06. The fair market value of the Foremost stock received was $1,235,625 and the amount of cash received was $3,000,000. Thus, petitioner's gain on the exchange was $4,163,691.94.

2. Grover D. Turnbow, 32 T.C. 646 (1959), *nonacq.*, 1960-1 CUM. BULL. 7.

3. Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960).

4. Turnbow v. Commissioner, 368 U.S. 337 (1961).

5. Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956); Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960).

6. Int. Rev. Code of 1939, ch. 1, § 112(a), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 1002).

7. Int. Rev. Code of 1939, ch. 1, § 112(b)(3), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 354(a)(1)).

8. Int. Rev. Code of 1939, ch. 1, §§ 112(g)(1)(A)-(F), 53 Stat. 37 (now INT. REV. CODE OF 1954, §§ 368(a)(1)(A)-(F)).

9. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(B), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 368(a)(1)(B)).

exchange *solely* for all or a part of its voting stock.[10] One of the major interpretative problems in reorganizations is the "solely for voting stock" requirement which is found only in "B" and "C" reorganizations.[11]

The United States Supreme Court, when confronted with a "C" reorganization in *Helvering v. Southwest Consolidated Corporation,*[12] held: " 'Solely' leaves no leeway Voting stock plus some other consideration does not meet the statutory requirement."[13] In *Howard v Commissioner*[14] 80.19 per cent of the acquired corporation's stock was acquired for voting stock and the remaining 19.81 per cent for cash. The Seventh Circuit Court of Appeals concluded that because of the cash payment, the transaction failed to meet the "solely for voting stock" requirement and thus was not within the ambit of the non-recognition provisions of section 112(b)(3) However, the court held the gain to be limited to the extent of the cash received. It is significant to note that no cash was received by the petitioners in the *Howard* case, and as a consequence, no gain at the time of the transaction ever arose.

Looking primarily to the language of section 112(c)(1), now section 356(a)(1) of the Internal Revenue Code of 1954, which provides that where an exchange would be tax free but for the receipt of property other than that permitted, then recognition of gain, if any, is to be limited to the amount of such property received, the court in *Howard* reasoned:

> *but for* the cash received in exchange for 19.81% of the common stock of *Binkley,* the transaction would have met the 'solely' requirement of § 112(g)(1)(B) and fallen within the scope of § 112(b)(3) To the extent that 'boot' was received, gain would be recognized under our interpretation of the application of § 112(c)(1) [15]

10. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(C), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 368(a)(1)(C)).

11. Two statutory exceptions to the "solely for voting stock" requirement are provided in "C" reorganizations which, however, are not extended to "B" reorganizations. First, in determining whether the acquisition is solely for stock, the assumption by the acquiring corporation of a liability of the acquired corporation, or the fact that property acquired is subject to a liability, shall be disregarded. Int. Rev. Code of 1939, ch. 1, § 112(g)(1)(C), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 368(a)(1)(C)) See generally Surrey, *Assumption of Indebtedness in Tax-Free Exchanges,* 50 YALE L.J. 1 (1940) Second, if in an exchange solely for voting stock property is acquired having a fair market value of at least eighty per cent of the fair market value of all the property of the acquired corporation, the remaining twenty per cent of fair market value can be acquired for consideration other than voting stock without disqualifying the exchange as a "C" reorganization. INT. REV. CODE OF 1954, § 368(a)(2)(B) [hereinafter cited as Code §]. See generally CAVITCH, OHIO CORPORATION LAW § 12.43[2] (1961); 3 MERTENS, FEDERAL INCOME TAXATION § 20.90 (1957) However, in using this second exception, the first exception that the assumption of liabilities or the taking of property subject to liabilities is disregarded as consideration, is reversed, and such liabilities are treated as money paid for the property. Code § 368(a)(2)(B)

12. 315 U.S. 194 (1942).

13. *Id.* at 198.

14. 238 F.2d 943 (7th Cir. 1956) See 57 COLUM. L. REV. 591 (1957).

15. 238 F.2d 943, 948 (7th Cir. 1956). To the same effect is Luther Bonham, 33 B.T.A. 1100 (1936)

The court further reasoned that if the presence of "boot" results in recognition of gain,

In effect, the court held that where "boot" is involved, the exchange is to be considered separate and apart from the "boot" received in determining whether it meets the non-recognition provision.[16]

Taking a position diametrically opposed to that of the Seventh Circuit Court in the *Howard* case, the Supreme Court in *Turnbow v. Commissioner*,[17] in a limited holding, set forth the rule that an actual reorganization as defined in the Code must exist before the "boot" provisions of section 112(c)(1) can apply. The Court reasoned that to indulge in the *but for* assumption applied in the *Howard* case would actually permit the negation of Congress' carefully composed definition and use of reorganization. It would further permit non-recognition of gains on what are, in reality, only sales, the full gain from which is immediately recognized and taxed under the general rule of section 112(a).[18] It is significant to note that the consideration ratio for the acquisition in *Turnbow* was thirty per cent stock and seventy per cent cash, while in *Howard* the ratio was eighty per cent stock and only twenty per cent cash. The low cash ratio in the *Howard* case, together with the fact that the appealing taxpayer in that case received no cash, might have persuaded the Supreme Court to follow the Seventh Circuit Court's interpretation had the *Howard* case been before the Court instead of the *Turnbow* case.[19]

It is submitted that the Supreme Court was justified in ruling that there must first be a reorganization as defined in the Code before the "boot" provisions of section 112(c)(1), now section 356(a)(1) of the Internal Revenue Code of 1954, can apply. It is difficult to conceive of any transaction which would not qualify as a reorganization under the *Howard* holding which, in effect, treats a transaction as a reorganization if the transaction would have met the statutory definition of

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it likewise results in recognition of loss. Int. Rev. Code of 1939, ch. 1, § 112(e), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 356(c)), the counterpart of Int. Rev. Code of 1939, ch. 1, § 112(c)(1), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 356(a)(1)), provides that where an exchange would be tax free but for the receipt of property other than that permitted, then no loss shall be recognized. Thus, a taxpayer desiring that a loss be recognized might convert what otherwise would be a legitimate reorganization into a sale by the payment of a trifling amount of cash.

The court also envisioned a situation where a small minority of dissident stockholders could completely block an other wise tax-free reorganization. However, since only eighty per cent control is requisite, this conclusion does not necessarily follow. Code § 368(c). See, favoring the *Howard* decision, Ayers & Repetti, *Boot Distributions under the '54 Tax Code*, 32 NOTRE DAME LAW. 414, 419 (1957).

16. Howard v. Commissioner, 238 F.2d 943, 948 (7th Cir. 1956).

17. 368 U.S. 337 (1961).

18. Int. Rev. Code of 1939, ch. 1, § 112(a), 53 Stat. 37 (now INT. REV. CODE OF 1954, § 1002), provides that the entire gain or loss upon an exchange or sale of property shall be recognized.

19. *Supreme Court Affirms Turnbow: Cash Kills B-type Reorganization*, 16 J. TAXATION 92 (1962).