

1968

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Recommended Citation

Stephen L. Kadish, *E Reorganizations--Recapitalizations and F Reorganizations--Changes in Identity, Form, or Place of Organization*, 19 Case W. Res. L. Rev. 1028 (1968)

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“E” Reorganizations—Recapitalizations and “F” Reorganizations—Changes in Identity, Form, or Place of Organization

Stephen L. Kadish

THE FIFTH and sixth types of reorganizations, found under subsections (E) and (F) of section 368(a)(1) of the *Internal Revenue Code of 1954* are quite different from those found in the first four subsections. The two principal differences are that “E”

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and “F” reorganizations involve only a single corporation and, unlike “B,” “C,” and “D” reorganizations, there are no complex statutory requirements which must be met. The *Code* has simply provided since 1921 that an “E” reorganization is “a recapitalization” and that an “F” reorganization is a “mere

change in identity, form or place of organization however effected.” The beguiling simplicity of these categories has required and received many years of judicial interpretation.

I. TYPE “E” RECAPITALIZATIONS

Because the *Internal Revenue Code* nowhere defines the term “recapitalization,” one must resort to the regulations and case law for guidance. While the Supreme Court has merely referred to a recapitalization as the “reshuffling of a capital structure within the framework of an existing corporation,”¹ the Third Circuit has defined recapitalization in more detail as “an arrangement whereby [the] stock [and] bonds . . . of the corporation are [re]adjusted as to amount, income or priority, or an agreement of all stockholders and creditors to change and increase or decrease [the] capitalization

¹ *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202 (1942).

or debts of [the] corporation or both"²

The regulations,³ rather than attempting a definition, give five examples of situations which constitute recapitalizations. The first situation involves bondholders who exchange their bonds for preferred stock; the second⁴ and fourth examples involve the issuance of common stock in exchange for outstanding preferred stock; the third⁵ example concerns the issuance of preferred stock in exchange for outstanding common; and the final example involves the issuance of new preferred stock in exchange for outstanding preferred on which dividends are in arrears.

It should be noted that these exchanges affect only the relationships between the corporation and its shareholders, because a recapitalization involves only a single corporation which receives no property itself but merely rearranges its obligations to its shareholders.⁶ In fact, a recapitalization can occur simply by a change in the corporate charter, without any exchange of stock or securities.⁷

A. *The Objectives of Recapitalization*

Before examining the various types of recapitalizations, it will be helpful first to consider some of the purposes for which recapitalization is utilized. For example, a corporation with one class of outstanding common stock can by recapitalization create two classes of common stock, one of which is nonvoting, in order to provide the voting shareholders sufficient control to fix management policies and at the same time not distort the equity participation or other rights of the nonvoting shareholders. Alternatively, the corporation might create a class of preferred stock to give fixed income to one set of shareholders while giving the benefit of the equity growth to other shareholders who are more active in the management of the business. The creation of preferred shares may help to fix the estate taxes on such shares and thus enable the holders to make gifts or otherwise aid them in estate planning. The creation of a class of preferred stock to supplement a corporation's sin-

² United Gas Improvement Co. v. Commissioner, 142 F.2d 216 (3d Cir. 1944).

³ Treas. Reg. § 1.368-2(e) (1955).

⁴ The second example is based on case law, e.g., Kistler v. Burnet, 58 F.2d 687 (D.C. Cir. 1932).

⁵ The third example is based on such cases as H.E. Muchnic, 29 B.T.A. 163 (1933), *acquiesced in*, XIII-1 CUM. BULL. 11 (1934).

⁶ Truman H. Newberry, 14 P-H Tax Ct. Mem. 643 (1945).

⁷ Rev. Rul. 56-654, 1956-2 CUM. BULL. 216.

gle class of common stock can also assist less affluent shareholders and employees to purchase a common equity interest in the corporation.⁸

A recapitalization may also be used by a corporation to simplify its complex capital structure. A corporation with several classes of stock outstanding may wish to convert these stocks to a single class in order to elect Subchapter S. Alternatively, a corporation may improve its credit rating by issuing additional shares of common stock in exchange for outstanding debentures or preferred stock, especially where the preferred stock dividends are in arrears. A recapitalization may also be used to facilitate corporate acquisitions by enabling either the acquiring or the acquired corporation to modify its capital structure.

B. *Types of Recapitalizations*

A recapitalization by means of an exchange of stock for outstanding bonds, which might be done in order to reduce the debt obligations of the corporation thereby improving its credit rating, is almost always acceptable to the Internal Revenue Service; the possibility of the exchange being viewed as a "bailout" of corporate earnings is low because the bondholders assume a position of lower priority in the corporate capital structure. The converse, an upgrading of priority, is not usually favored as will be indicated below. Because a bondholders' claim for accrued interest is not considered severable from the underlying debt, exchanges of stock for outstanding bonds, including exchanges stated to be for unpaid interest,⁹ may be undertaken even when interest is in arrears on the bonds.¹⁰ These exchanges will be tax free even if the stock received is worth less than the principal amount of the securities surrendered.¹¹ Similarly, the exchange of preferred stock which

⁸ For example, assume that a corporation had a net worth of \$1,000,000 and that a young group of executives wished to purchase a 50 percent equity interest because they desired a large voice in management and a substantial participation in the growth of the corporation. In order to achieve their objectives they would ordinarily have to raise \$500,000. By recapitalizing the company so that \$600,000 of preferred stock is issued to the existing shareholders in exchange for 60 percent of their common stock, the equity interest of the remaining common stock would be \$400,000, and purchase of a 50 percent interest would require a purchase price of only \$200,000.

⁹ See Estate of William Bernstein, 21 T.C. 100 (1952), *acquiesced in*, 1955-1 CUM. BULL. 3.

¹⁰ See Commissioner v. Carman, 189 F.2d 363 (2d Cir. 1951), *acquiesced in*, 1959-1 CUM. BULL. 76; Treas. Reg. §§ 1.368-2(c) (2), (4) (1955).

¹¹ Rev. Rul. 59-222, 1959-1 CUM. BULL. 80. See also Rev. Rul. 58-546, 1958-2 CUM. BULL. 143. One word of caution should be mentioned — the Government still

has arrearages for new common or preferred will qualify as a recapitalization, but if it is done *solely* for the purpose of discharging arrearages it will constitute a taxable distribution under section 305(b)(1).¹²

The surrender of bonds in exchange for bonds is generally tax free, but the fair market value of any excess principal amount constitutes "boot" under sections 354(a)(2)(A) and 356(d)(2)(B).¹³ This "boot" will be taxable as capital gain if it does not have "the effect of the distribution of a dividend" under section 356(a)(2). The Government, however, can usually be expected to contend that there has been an "automatic dividend" under the rule of *Commissioner v. Bedford's Estate*.¹⁴ It should be noted that the existence of "boot" will not necessarily jeopardize the nonrecognition treatment of the recapitalization. This is also true where, incident to a recapitalization, a small amount of cash is paid either as a premium or as a substitute for prior undeclared dividends. Even though the recipients are taxed on the cash received, the transaction may still constitute a tax-free recapitalization.¹⁵

The exchange of stock for stock of a different class will usually constitute a tax-free recapitalization.¹⁶ In addition, the exchange of common for common, or preferred for preferred, may qualify for nonrecognition treatment under section 1036, without any necessity for compliance with the reorganization provisions.¹⁷

In a recapitalization common stock is often exchanged for both

has outstanding a nonacquiescence in the case of *Commissioner v. Capento Sec. Corp.*, 140 F.2d 382 (1st Cir. 1944), and might contend that the corporation received cancellation-of-indebtedness income under section 61(a)(12) of the *Code*.

¹² Treas. Reg. § 1.368-2(e)(5) (1955).

¹³ See Treas. Reg. §§ 1.356-3(b)(4), (6) (1955).

¹⁴ 325 U.S. 283 (1945). *But cf.* *Hawkinson v. Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Idaho Power Co. v. United States*, 161 F. Supp. 807 (Ct. Cl. 1958).

¹⁵ See, e.g., *Skenandoa Rayon Corp. v. Commissioner*, 122 F.2d 268 (2d Cir. 1941); *Humphries Mfg. Co.*, 45 B.T.A. 114 (1941); *J. Weingarten, Inc.*, 44 B.T.A. 798 (1941), *acquiesced in*, 1942-2 CUM. BULL. 19.

¹⁶ For example, an exchange of stock for stock may be useful where two family groups of shareholders wish to preserve their respective degrees of voting control. A single class of outstanding common stock could be exchanged for two newly created classes of common stock each with definite dividend and voting rights and each class restricted so that it may not be transferred outside of the family group to which it was issued. The majority shareholder group could then use a voting trust in order to assure continuity of control.

¹⁷ See Treas. Reg. § 1.1036-1(a) (1956). Qualifying for nonrecognition treatment under section 1036 may become important, for example, when there is an attempt to obtain clearance under section 367 for transactions involving foreign corporations. Rev. Rul. 64-156, 1964-1 CUM. BULL. 139, provides that section 1036 overrides section 368 for purposes of a section 367 ruling, and Rev. Rul. 66-171, 1966-1 CUM. BULL. 181, reaches the same result for an "F" reorganization.

common and preferred stock, and although such an exchange is generally tax free, the preferred stock may constitute section 306 "hot" stock, thereby causing recognition of ordinary income upon disposition.¹⁸ Generally, such a transaction is tested for section 306 consequences by ascertaining what the "effect" would have been if cash had been distributed instead of the preferred stock.¹⁹ It should be noted that there can be no section 306 stock if the corporation had no earnings and profits at the time of recapitalization.²⁰ The use of a "callable" common stock in a recapitalization may also result in a section 306 "taint."²¹

An exchange of stock for bonds is the most controversial and complex area of recapitalizations. This type of exchange is closely scrutinized by the Government, for not only can a corporation deduct the interest payments on the bonds (in contrast to the non-deductibility of dividends), but the exchange may be a prelude to a bailout of earnings and profits at capital gains rates through the sale of the bonds or their retirement under section 1232(a)(1).²² The landmark case in the area, *Bazley v. Commissioner*,²³ decided by the Supreme Court under the 1939 Code, provided at best a set of ambiguous criteria for disqualification of exchanges of bonds for stock. In *Bazley* a family-controlled corporation with a large amount of earnings issued stock and bonds in exchange for outstanding stock. The distribution was pro rata, and the bonds were callable at any time. The Court found a lack of business purpose for the transaction. Small wonder that the transaction was held not to be a tax-free recapitalization. By contrast, in several cases since *Bazley*, after determining the existence of valid business reasons, lack of control and marketability, and nonpro rata distributions, lower courts have permitted the tax-free issuance of bonds in recapitalizations.²⁴ Thus it appears that there are instances in which

¹⁸ See generally Lowy, *When Does Section 306 Taint Preferred Stock Received in Reorganizations — A Latter Day Concept of Bailout*, 28 TAX LAWYER 191 (1967) (formerly ABA TAXATION SECTION).

¹⁹ See CODE § 306(c) (1) (B) (ii); Treas. Reg. 1.306-3 (d) (1955).

²⁰ CODE § 306(c) (2). See also Rev. Rul. 59-84, 1959-1 CUM. BULL. 71.

²¹ Rev. Rul. 57-132, 1957-1 CUM. BULL. 115.

²² See, e.g., *Chamberlin v. Commissioner*, 207 F.2d 462 (6th Cir. 1953), cert. denied, 347 U.S. 918 (1954) (decided under the 1939 Code). The utilization of bailouts is now restricted substantially by the "boot" provisions in sections 354 and 356 of the 1954 Code.

²³ 331 U.S. 737 (1947).

²⁴ E.g., *Berner v. United States*, 282 F.2d 720 (Ct. Cl. 1960); *Davis v. Penfield*, 205 F.2d 798 (5th Cir. 1953) (examples of nonfamily, less marketable situations);

stock can be exchanged tax free for bonds, but an advance Internal Revenue Service ruling should ordinarily be sought to assure non-recognition of gain.

C. Collateral Considerations

In order to qualify a recapitalization as a tax-free "E" reorganization, it is necessary to have a plan of reorganization (although this need not necessarily be contained in a formal written document) and to meet certain reporting requirements.²⁵ Moreover, in addition to compliance with the mechanical requirements of the Code and regulations, it is necessary that the recapitalization be motivated by a valid business purpose.²⁶ It is clear that this purpose must be more than the avoidance of income taxes,²⁷ and, while earlier cases required the business purpose to be that of the corporation, some recent cases have found the business purposes of shareholders to be sufficient.²⁸ Some business purposes which have been judicially approved are the protection of assets from the claims of creditors,²⁹ the facilitation of shareholder estate planning,³⁰ the reduction of the corporate interest burden,³¹ and the redistribution of voting rights.³²

Unlike some of the other types of reorganizations, continuity of interest may not be necessary in a recapitalization.³³ However, departing shareholders may be required to recognize their gain in full under sections 354, 356, and 302.³⁴

D. Effect on the Corporation

A corporation which issues new stock in a recapitalization does

Daisy Seide, 18 T.C. 502 (1952); Wolf Envelope Co., 17 T.C. 471 (1951), *nonacquiesced in*, 1952-1 CUM. BULL. 6 (nonpro rata situations which qualified as tax free).

²⁵ C.T. Investment Co. v. Commissioner, 88 F.2d 582 (8th Cir. 1937); James G. Murrin, 24 T.C. 502, (1955), *acquiesced in*, 1955-2 CUM. BULL. 7; National Pipe & Foundry Co., 19 B.T.A. 242 (1930), *nonacquiesced in*, XI-1CUM. BULL. 10 (1932).

²⁶ Gregory v. Helvering, 293 U.S. 465 (1935), *aff'g*, 69 F.2d 809 (2d Cir. 1934). The appropriate regulations are Treas. Reg. §§ 1.368-1(b), (c) (1955).

²⁷ See J.D. & A.B. Spreckels Co., 41 B.T.A. 370 (1940).

²⁸ See, e.g., Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962); Lewis v. Commissioner, 176 F.2d 646 (1st Cir. 1949).

²⁹ Howard Hotel Corp., 39 B.T.A. 1147 (1939), *nonacquiesced in*, 1939-2 CUM. BULL. 54.

³⁰ Estate of Parshelsky v. Commissioner, 303 F.2d 14 (2d Cir. 1962).

³¹ Annis Furs, Inc., 2 T.C. 1096 (1943), *acquiesced in*, 1944 CUM. BULL. 2.

³² Wolf Envelope Co., 17 T.C. 471 (1951).

³³ Berner v. United States, 282 F.2d 720 (1960); Alan O. Hickok, 32 T.C. 80 (1959), *nonacquiesced in*, 1959-2 CUM. BULL. 8.

³⁴ See Treas. Reg. § 1.354-1(d) (1960).

not realize gain on the issuance.³⁵ If a tax benefit has been obtained by the accrual of interest deductions, the Internal Revenue Service may contend that a corporation which substituted new bonds for outstanding stock and bonds received cancellation-of-indebtedness income under section 61(a)(12) unless an election is made under section 108(a) to reduce the corporation's basis in the bonds in accordance with section 1017.³⁶ If no gain is recognized by the shareholders in a recapitalization, the corporation's earnings and profits are not affected. If the shareholders do have gain which is treated as a dividend under section 356(a)(2), the corporate earnings and profits are reduced by the amount of the dividend.³⁷ Since the corporate existence is unaffected by a recapitalization, all tax attributes such as net operating losses, accounting methods, and bad debt reserves are preserved without the necessity of complying with section 381.³⁸ Thus, the limitations on net operating loss carryovers provided by section 382 are inapplicable to recapitalizations despite the possibility of shifts in stock ownership.

For Ohio personal property tax purposes there had been, prior to 1963, a question whether the distribution of a new class of stock would constitute taxable "income yield" under *Ohio Revised Code* section 5701.10. The Supreme Court of Ohio then held that a distribution of common stock with respect to existing common stock was not income yield,³⁹ but that a distribution of preferred on common was income yield.⁴⁰ The latter result was changed by legislation in 1963 so that all stock distributions pursuant to a recapitalization are now nontaxable for Ohio personal property tax purposes.⁴¹

II. TYPE "F" REORGANIZATIONS

Section 368(a)(1)(F) provides tax-free reorganization treatment for those corporate changes which result in "a mere change in identity, form, or place of organization, however effected." As with recapitalizations, the *Internal Revenue Code* gives no assistance to the practitioner in defining or illustrating the content of

³⁵ Rev. Rul. 59-222, 1959-1 CUM. BULL. 80.

³⁶ See Rev. Rul. 58-546, 1958-2 CUM. BULL. 143.

³⁷ Treas. Reg. § 1.312-11(b) (1955).

³⁸ See Rev. Rul. 54-482, 1954-2 CUM. BULL. 148.

³⁹ *Weaver v. Bowers*, 173 Ohio St. 1, 179 N.E.2d 50 (1962).

⁴⁰ *Way v. Bowers*, 175 Ohio St. 331, 194 N.E.2d 772 (1963); *Coburn v. Bowers*, 173 Ohio St. 4, 179 N.E.2d 50 (1962).

⁴¹ OHIO REV. CODE ANN. § 5701.10 (Page Supp. 1966).

an "F" reorganization. Moreover, the Treasury Department, in issuing its regulations completely omitted this type of reorganization, which, although at one point almost deleted from the *Code*, still has substantial utility in the area of corporate attribute carryovers under section 381, and in the Subchapter S and Small Business Stock areas of sections 1371-78 and 1244.

The scope of the "F" reorganization is still uncertain. In the last few years it has been the statutory backdrop for considerable litigation. There have been recent cases in the area of net operating loss carryovers as well as the so-called "liquidation-reincorporation" area. Fortunately for taxpayers, the Commissioner has met with little success in the latter area, mainly because the courts have narrowly construed the ambit of the "F" reorganization.⁴² In one case it has been said to encompass "only the simplest and least significant of corporate changes,"⁴³ and in another case it was held to be "limited to cases where the corporate enterprise continues uninterrupted, except perhaps for a distribution of some of its liquid assets" so that "there is a mere change of corporate vehicles, the transferee being no more than the alter ego of the transferor."⁴⁴ An "F" reorganization is generally limited to a single corporation⁴⁵ but it also includes reincorporation in another State by the formation of a new corporation into which the existing corporation is merged.⁴⁶ All corporate assets must be promptly transferred to the new corporation except those used to satisfy dissenting shareholders.⁴⁷

Where a transaction constitutes an "F," as well as constitutes an "A," "C," or "D" reorganization, the Internal Revenue Service has ruled that the transaction will be treated as an "F" reorganization for purposes of carryovers.⁴⁸ Thus, the taxable year of the predecessor corporation is not terminated as would ordinarily occur under section 381(b)(1). Moreover, section 381(b)(3), which pro-

⁴² See cases cited notes 43-44 *infra*. *But cf.* Reef Corp. v. Commissioner, 368 F.2d 125, 136-37 (5th Cir. 1966) (dictum).

⁴³ Hyman H. Berghash, 43 T.C. 743, 752 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

⁴⁴ Pridemark, Inc. v. Commissioner, 345 F.2d 35 (4th Cir. 1965), *rev'g* 42 T.C. 510 (1964).

⁴⁵ Associated Machine, 48 T.C. 277 (1967); Estate of Bernard F. Stauffer, 48 T.C. 318 (1967).

⁴⁶ Rev. Rul. 57-276, 1957-1 CUM. BULL. 126.

⁴⁷ Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir.), *cert. denied*, 293 U.S. 611 (1934).

⁴⁸ Rev. Rul. 57-276, 1957-1 CUM. BULL. 126.

hibits carrybacks of net operating losses from taxable years after an "A," "C," or "D" reorganization to earlier years of the acquired corporation, is inapplicable.⁴⁹ The Service has also stated that an "F" reorganization will not jeopardize the Small Business Stock status of outstanding section 1244 stock which is replaced,⁵⁰ nor will a valid Subchapter S election be terminated where, pursuant to an "F" reorganization, a corporation merges into a new corporation formed in a different State if the new corporation meets all of the Subchapter S requirements.⁵¹

In order to obtain a favorable advance revenue ruling, the Internal Revenue Service has stated that there can be no significant change in stock ownership or proprietary interest, with the exception to allow dissenting shareholders holding less than 1 percent of the outstanding shares of the predecessor corporation to refuse to acquire stock in the successor corporation.⁵²

Procedurally, the question arises as to whether a corporation which has undergone "F" reorganization needs to alter its reporting to the Internal Revenue Service. Under the income tax regulations, certain information must be filed with the income tax return for the taxable year during which a reorganization occurs. Beyond this reporting requirement, there appears to be no published position of the Internal Revenue Service as to whether a new employer's identification number is required, or whether the entity is treated as a new corporation for purposes of the Federal Insurance Contributions Act, Federal Unemployment Tax Act and federal excise taxes, and for purposes of reporting to State agencies. Since an "F" reorganization involves only a single corporation and is merely "a change in identity, form, or place of organization," it would seem that no new reporting requirements would have to be met. This conclusion appears to be supported by a recent ruling in the federal employment tax area.⁵³

The following examples of transactions which have been held to be "F" reorganizations illustrate some of the varieties of this type of reorganization and the fact that a corporation may some-

⁴⁹ *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), *cert. denied*, 353 U.S. 983 (1957); *see* *Casco Products Corp.*, 49 T.C. 32 (1967); *Associated Machine*, 48 T.C. 277 (1967); *Estate of Bernard F. Stauffer*, 48 T.C. 318 (1967).

⁵⁰ Treas. Reg. § 1.1244(d)-3(d)(1) (1960).

⁵¹ Rev. Rul. 64-250, 1964-2 CUM. BULL. 333.

⁵² Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

⁵³ Rev. Rul. 68-63, 1968 Int. Rev. Bull. No. 6, at 21. *Compare id.*, with S.S.T. 188, 1937-2 CUM. BULL. 377, and Rev. Rul. 62-60, 1962-1 CUM. BULL. 186.

times undergo an "F" reorganization without realizing it. Obtaining a new corporate charter in the same State or in a different State⁵⁴ constitutes an "F" reorganization, as does the act of merely renewing a corporate charter.⁵⁵ It has been indicated that the conversion of a federally chartered savings and loan association into a State-chartered institution constitutes an "F" reorganization.⁵⁶ Similarly, the conversion of a State-chartered savings and loan association into a national bank constitutes an "F" reorganization.⁵⁷ The Internal Revenue Service has recently ruled that there could be an "F" reorganization where a corporation, desiring to conduct its business in trust form, established an association taxable as a corporation under section 7701(a)(3), and transferred all of the corporate assets subject to liabilities in exchange for transferable certificates of beneficial interest which it then distributed to its shareholders in exchange for their stock. Under these circumstances the trust was held to qualify as a corporation for purposes of section 368.⁵⁸

Finally, some recent cases illustrate the importance currently attached to qualification as "F" reorganizations in regard to net operating losses. Under section 381(b), a net operating loss incurred by an acquiring corporation prior to a reorganization cannot be carried back to a prior taxable year of the acquired corporation, unless the transaction qualifies as an "F" reorganization. Hence, a corporation which finds itself with a net operating loss in a year shortly after a "change" of corporate identity may attempt to bring itself within the "F" category in order to avail itself of a carryback of the operating loss to the successful years prior to the "change."

During 1967, the Commissioner prevailed twice in the contention that the amalgamation of more than one corporation into a single corporate entity could not qualify as an "F" reorganization, regardless of the common shareholdings. In *Estate of Barnard H. Stauffer*,⁵⁹ one individual owned all of the stock in three corporations which operated weight-reducing businesses in several States. In order to centralize operations, he decided to combine all operations within the framework of a New Mexico corporation created

⁵⁴ See *Ahles Realty Corp. v. Commissioner*, 71 F.2d 150 (2d Cir.), cert. denied, 293 U.S. 611 (1934); *George Whittell & Co.*, 34 B.T.A. 1070 (1936).

⁵⁵ *Newmarket Mfg. Co. v. United States*, 233 F.2d 493 (1st Cir. 1956), cert. denied, 353 U.S. 983 (1957).

⁵⁶ *Cf. Marr v. United States*, 268 U.S. 536 (1925).

⁵⁷ 1966 private letter ruling.

⁵⁸ Rev. Rul. 67-376, 1967 INT. REV. BULL. NO. 44, at 13.

⁵⁹ 48 T.C. 277 (1967).

for this purpose. A ruling was obtained from the Revenue Service that the transaction constituted a valid "A" reorganization. In the 4-month fiscal year following the reorganization, the surviving New Mexico corporation had a substantial operating loss which it attempted to offset against the prereorganization income of the other three corporations in the 8 months prior to the reorganization, on the theory that an "F" reorganization had occurred. Even more substantial losses were incurred by the new entity in the next full fiscal year and it attempted to carry these back against the prereorganization income of the three operating corporations on the same theory. The Commissioner took the position that the combination of two or more corporations each of which had conducted a separate business could not qualify as an "F" reorganization because more than a single corporation was involved. The merger of three viable corporations into a single new corporate entity involved changes that were too far reaching for the transaction to be dismissed as a "mere change in identity, form, or place of organization." Judge Raum, in a Court Reviewed opinion with no dissents, found for the Commissioner. The court stated that the corporation had not merely moved to New Mexico but in addition many corporate changes had occurred. The fact that Mr. Stauffer was at all times the sole shareholder and the fact that the assets were unchanged could not minimize the extent of the transaction. The separateness of the corporate entities was recognized but the taxpayer's attempt to expand the coverage of "F" reorganizations was rejected. The Tax Court in the *Stauffer* case expressly renounced its 1964 decision in *Pridemark, Inc.*⁶⁰ (which had been reversed in part by the Fourth Circuit)⁶¹ and rejected an alternative holding of the Fifth Circuit in *Davant v. Commissioner*,⁶² both of which had given far broader scope to "F" reorganizations.

The day after the *Stauffer* decision, Judge Harron decided *Associated Machine*,⁶³ which involved two corporations that had combined. Although the transaction itself was a tax-free "A" reorganization, the decision resulted in a substantial tax detriment to the taxpayer. Net operating loss carrybacks were denied for the years after the merger because the court found that more than a "mere" change of form had occurred.

⁶⁰ 42 T.C. 510 (1964).

⁶¹ *Pridemark, Inc. v. Commissioner*, 345 F.2d 35 (4th Cir. 1965).

⁶² 366 F.2d 874 (5th Cir. 1966).

⁶³ 48 T.C. 318 (1967).

As in the liquidation-reincorporation cases, it sometimes suits the Commissioner's purposes to argue for the recognition of an "F" reorganization. In *Dunlap & Associates, Inc.*⁶⁴ he used this approach by fragmenting a series of transactions into one "F" and two "B" reorganizations rather than a single integrated reorganization. Had a single plan been found, the closing of a taxable year would have occurred.⁶⁵ Because an "F" reorganization was found, the taxable year of the transferred corporation did not close, and an additional surtax exemption was denied. This case illustrates that especially in the reorganization area, even under the apparently simple language of "F" reorganizations, the ingenuity and power of the Commissioner to recast transactions should not be underestimated.

The Commissioner has not won all of the 1967 cases dealing with "F" reorganizations. In *Holliman v. United States*,⁶⁶ a district court in Alabama found an "F" reorganization where all of the old corporation's assets were acquired in a bulk sale and a new corporation was formed in order to settle creditors' claims. The new corporation continued to operate the business. Relying on the Fifth Circuit's statement in *Davant v. Commissioner*,⁶⁷ which the Tax Court had rejected in *Stauffer*, the District Court called the transaction merely a change of vehicle rather than of substance and pointed out that the shareholders, assets, and nature of the business operations had remained unchanged. Thus the taxpayer, who was the trustee in bankruptcy of the shareholders, was permitted to offset net operating losses which occurred subsequent to the arrangement with creditors, against profits prior to that time. All that had occurred, said the court, was a change of name and a scaling down of debts, which were acts no broader in scope than the mere changes permitted by the statute.

Finally, the taxpayer in *Casco Products Corp.*⁶⁸ persuaded a majority of the Tax Court that a series of complex corporate maneuvers designed to eliminate minority stockholders constituted a redemption (albeit in reorganization clothing) which fell outside of section 368. In that case Standard Kollsman Industries, Inc. acquired 91 percent of Casco Products Corporation by a public tender

⁶⁴ 47 T.C. 542 (1967).

⁶⁵ CODE § 381(a)(2)(B).

⁶⁶ 67-2 U.S. Tax Cas. 9737 (D.C. Ala. 1967).

⁶⁷ 366 F.2d 874 (5th Cir. 1965).

⁶⁸ 49 T.C. 32 (1967).

offer in 1960 and early 1961. In order to eliminate dissidents among the remaining 9 percent shareholders, a new Connecticut corporation, SKO, Inc., was formed as a wholly owned subsidiary of Standard Kollsman. A merger was then consummated whereby Casco was merged into SKO, Inc. Under the terms of the merger agreement the minority shareholders received only cash for their Casco stock and were thereby eliminated as shareholders. SKO, Inc. then changed its corporate name to Casco Products Corporation and continued the business of the former Casco entity in exactly the same manner, with the same customers, employees, and so forth. No tax problem would have arisen had the new Casco entity not suffered a net operating loss of approximately \$1,500,000 for calendar year 1961. Had there been no merger, the old Casco corporation clearly could have used this loss to obtain a refund of its taxes paid during the prior 3 taxable years under section 172 by applying the net operating losses against the income it had earned in those years. Because of the merger, however, it became imperative for the taxpayer to prove that either an "F" reorganization had taken place or that there had in substance been no reorganization, so that the net operating loss of the new entity could be carried back against the profits of the old entity. The Revenue Service argued that there had been a statutory merger ("A" reorganization) but not an "F" reorganization, because there had been a 9 percent shift in proprietary interest, which, under the Service's position⁶⁹ would be more than the permissible 1 percent and thus more than a "mere" change in identity had taken place. Speaking for the majority, Judge Tannenwald "declined the invitation" of both parties to determine whether an "F" reorganization had taken place. Viewing the entire set of transactions as a "squeezeout" technique utilized in lieu of a redemption, and, stating that "[t]ax-wise, New Casco was merely a meaningless detour along the highway of redemption of the minority interests in Old Casco," the majority held that "the merger was a reorganization in form only and should consequently be ignored as such. What took place was a redemption of nine percent of the Old Casco shares and no more."⁷⁰ The loss carryback was therefore permitted. Five judges dissented stating that the old and new corporations were separate viable en-

⁶⁹ Rev. Rul. 66-284, 1966-2 CUM. BULL. 115.

⁷⁰ This raises at least two interesting questions: the ability of a taxpayer to argue that the "substance" of a transaction should take precedence over the form in which he himself has cast it; and secondly, when should one section of the *Code* have priority over another, assuming both are applicable to the same transaction.

tities with more than transitory lives. Recognizing that the question of whether the transaction constituted an "F" reorganization was a "teasing and difficult one," they believed that it should nevertheless have been decided.

Both the majority and dissenting opinions in *Casco* reflect the difficulty of determining the scope of "F" reorganizations. Until there is further litigation it will be difficult to know whether this section has substantial scope. Nevertheless tax practitioners should be aware of its possibilities as well as its pitfalls.