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TRANSFER OF BUSINESS THROUGH TAX-FREE REORGANIZATION

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Almost daily, the newspaper financial pages report the acquisition by a large corporation of the business of some smaller corporation. More often than not, these acquisitions are effected through some type of tax-free exchange under the reorganization provisions of the Internal Revenue Code and the corresponding provisions of various state income tax laws.[1] The opportunities for tax-saving or tax-postponement which these provisions offer must be considered whenever the transfer of a corporate business is contemplated.

Tax-free reorganizations may take any one of several basic forms, but whatever the form, the end result is generally the same. When the reorganization is completed, the sellers (or transferors, to use the statutory term) own securities of the acquiring corporation (transferee) in place of the stock they previously held. This result is accomplished without realization to the transferor of either capital gains or dividends, although the transferor's income tax basis for the securities transferred is carried over to the securities received. If the transferor subsequently sells his new securities, he has merely postponed the tax on his capital gain. However, this postponement may enable him to schedule sales so that the recognition of gain occurs in years with offsetting losses or perhaps in years with lower applicable tax rates. Often, a transferor who receives securities in a tax-free reorganization intends to retain these securities for the balance of his lifetime in order to achieve for his heirs a step-up in basis at death, without payment of any income tax on the gain.

While the news stories are concerned primarily with acquisitions involving large and well-known corporations, the reorganization techniques employed in these transactions are equally applicable to cor-

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[1] No attempt is made herein to discuss the reorganization provisions of the income tax laws of particular states. Although such laws are usually patterned after the federal provisions, the applicable state statutes must always be reviewed. In Wisconsin, the reorganization provisions are almost identical to the federal provisions. See Wis. Stats. §§71.354, 71.361 and 71.368 (1957).

porations of all sizes. The attorney representing prospective transferors of a corporate business, whether a million-dollar corporation or a relatively small local business, must always consider the possibility of framing the transfer as a reorganization. The purpose of this article is to offer some practical suggestions regarding the use of reorganization techniques when representing the transferor of a small business. It is not intended as a substitute for basic source material. The reorganization provisions of the Internal Revenue Code, and the regulations thereunder must be re-examined with reference to the specific facts whenever a tax-free reorganization is contemplated.

Whether to seek an advance ruling from the Internal Revenue Service on the tax status of proposed reorganizations depends on the facts of the particular case. In cases involving unique and unusual facts, protection of the transferor may require that the transfer be made conditional on the securing in advance of a favorable ruling from the national office of the Internal Revenue Service. In other cases, the transferor's counsel may be able to give an unqualified favorable opinion, thus permitting the reorganization to proceed without the four to six weeks' delay that a tax ruling generally entails. In a few cases, the transferor may be willing to proceed with a reorganization believed to be tax-free, but known to involve an issue on which the Internal Revenue Service has taken an unfavorable position. In such cases, no request for ruling should be made, as the request will merely serve to call particular attention to the contemplated transactions. While a ruling request may be withdrawn at any time prior to issuance of a ruling, the Service retains all correspondence and exhibits. The regulations specifically provide that even though a request is withdrawn, the National office may furnish its views to the local District Director, and the information submitted may be used in a subsequent audit of a taxpayer's return.[2] In doubtful cases, an informal telephone conference with a representative of the Rulings Division is sometimes helpful in deciding whether a ruling should be requested. Such a conference in which the name of the transferor need not be disclosed, may reveal whether the Service has an established policy, not reflected in any published regulations or rulings, covering the problem at hand.

Regardless of the circumstances if a decision is made to seek a ruling, the regulations with respect to the form and content of ruling requests, and the requirements with respect to information to be furnished should be strictly followed.[3] These generally include the furnishing of balance sheets of all parties to the reorganization, a statement of the business purposes of the reorganization and a statement of relevant authorities supporting the ruling request. If time is of the

[2] Reg. §601.201 (g).
[3] Reg. §601.201 (f) (1).

essence, priority in consideration should be requested and the reasons given therefor. It is often helpful to arrange a conference with a representative of the Rulings Division in Washington at the time of filing, particularly if speed in obtaining the ruling is important.

Before looking at the reorganization provisions in detail, mention should be made of a bill currently pending before the Ways and Means Committee of the House of Representatives, which, if enacted, would involve substantial revision of the reorganization provisions.[4] This bill was drafted by a special Advisory Group of tax practitioners for the Ways and Means Committee. Attention will be called to some of the more important substantive changes which would result if the bill is enacted in its present form.

The reorganization provisions of the Internal Revenue Code can perhaps best be discussed by applying them to particular facts. Two typical situations in which the reorganization techniques offer substantial tax savings to an individual desiring to transfer a small business will be used as a basis for discussion in this article. One involves acquisition of a business by an outside party; the other an acquisition by persons who already own a minority interest.

Situation A

Mr. Able founded Company A, a small manufacturing corporation, about 30 years ago and is its President and sole shareholder. The business has prospered and grown. Although it is difficult to put a dollar value on the stock of Company A, Mr. Able believes the Company is worth at least five times his original investment. The Company's property also has a market value considerably in excess of its tax basis. Mr. Able is 65 years of age and is anxious to dispose of his business and retire from active management. He has no sons or other members of his family who are active or interested in the business, and no employees with sufficient ability or capital to acquire the business. Even apart from his desire to retire, Mr. Able believes it is better for him to dispose of his business during his lifetime than to leave the disposition to his widow after his death. By selling now, he has a going, profitable business to offer and can assist the purchaser in getting under way. For this reason, he believes he could secure a better price now than could be obtained by his widow after his death, particularly if a sale were forced in order to raise cash for payment of death taxes. He is fearful of the valuation which might be put on his stock for tax purposes, especially since almost his entire estate is tied up in his business.

Mr. Able is aware that on his death, his widow and children will obtain a stepped-up income tax basis on the assets in his estate. He

[4] H. R. 4459, 86th Cong. 1st Sess., introduced February 12, 1959.

hesitates, therefore, to enter into any transaction which would force him to realize for tax purposes the substantial capital gain which a cash sale would produce.

Situation B

Mr. Baker owns two-thirds of the common stock (the only class outstanding) of Company B. Mr. Baker's situation is similar to that of Mr. Able, except that Mr. Baker has two sons who have been active with him in the business and who own the other third of the stock. The sons have assumed increasing responsibility in recent years and are ready to take over full management when Mr. Baker retires. Mr. Baker believes his sons will have more enthusiasm for the business if they have full voting control of Company B after his retirement. Company B has never paid dividends on its common stock. Mr. Baker is willing to retain a financial interest in Company B after retirement, but will need to have a fair return on this investment as it will be the primary source of his support once his present salary terminates. He does not have a sufficient estate to warrant substantial gifts of stock to his sons. The sons do not have sufficient funds to purchase his stock, and even if they did, Mr. Baker would be reluctant to realize the large capital gain.

Basic Requirements of Tax-Free Reorganizations

The sections of the Internal Revenue Code dealing with reorganizations often seem complicated and mysterious, particularly to the practitioner who does not specialize in tax matters. Yet, the basic pattern is relatively simple. A transaction intended to qualify as a tax-free reorganization must satisfy two basic statutory requirements. First, the transfer or exchange must be one of a type specifically described as tax-free by the Internal Revenue Code. Second, the entire transaction must fall within one of the statutory definitions of "reorganization." Superimposed on these statutory requirements are the so-called "business purpose" and "continuity of interest" rules, which have grown out of court decisions and are now restated in the regulations under Section 368 of the Code.[5] The "business purpose" rule stems from the decision of the Supreme Court in the frequently cited case of *Gregory v. Helvering*.[6] The case held that literal compliance with the statutory reorganization provisions is not enough: a transaction is not a reorganization if there is no "business or corporate purpose" for the transaction other than the avoidance of federal income taxes. The Commissioner's regulations now expressly recognize the amalgamation of two corporate enterprises into a single corporate structure as satisfying the "business purpose" requirement.[7]

[5] Reg. §1.368-1(b).
[6] 293 U.S. 465 (1935).
[7] Reg. §1.368-1(b).

The "continuity of interest" rule requires that the transferors of stock or securities in a reorganization must have a continuing proprietary interest in the corporation resulting from the reorganization.[8] As to some types of reorganizations, the rule is automatically satisfied by meeting the statutory definition of reorganization[9] Attention will be called to fact situations where the "business purpose" and "continuity of interest" rules require special attention.

Mr. Able's Problem—Reorganization with Another Corporation

We turn now to the problems faced by Mr. Able. We will assume that Mr. Able is approached by a larger firm, Company X, which would like to acquire the business of Company A. The common stock of Company X is publicly traded, has an established market value, and pays regular dividends. What practical alternatives are available to Mr. Able as he negotiates with Company X?

Company X may be willing to make a cash purchase of all of Mr. Able's stock, or of all of the assets of Company A. Both of these alternatives are undesirable from Mr. Able's point of view, at least for tax purposes, because of the large capital gain involved. In some cases, of course, non-tax factors, such as a present need for cash for particular purposes or a desire to diversify, may make a cash sale desirable. We will assume, however, that Mr. Able rejects any type of cash sale because of the large capital gain tax involved and insists that the transaction be negotiated as some form of tax-free exchange. At his age, in particular, the step-up in basis which will result at his death must be given considerable weight in deciding whether to realize capital gains.

Mr. Able may achieve non-recognition of gain or loss by either of two basic types of exchanges. The so-called "stock" exchange is provided for in Section 354 which provides, in general, that no gain or loss is recognized if Mr. Able exchanges his stock in Company A solely for stock or securities of Company X in pursuance of a plan of reorganiation. The "asset" exchange is described in Section 361, which states that no gain or loss will be recognized if Company A, in pursuance of a plan of reorganization, exchanges substantially all of its assets for stock or securities of Company X.

The requirement that the exchange be "in pursuance of a plan of reorganization," appears in both Sections 354 and 361. What is a plan of reorganization and how is it effected? In Section 368(a)(1), the word "reorganization" is defined to include six specific types of transactions. The definition excludes all other types of transactions. Four of the six types of transactions described as reorganizations will be

[8] See Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933), and LeEulle v. Scofield, 308 U.S. 415 (1940).

[9] See, for example, §§368(a)(1)(B) and 368(a)(1)(C).

described in this article. These are the types set forth in Sections 368(a)(1)(A), (B), (C), and (E), reading as follows:

> (A) a statutory merger or consolidation;
>
> (B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);
>
> (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock, the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;
>
> (E) a recapitalization; * * *

For convenience, these four types of transactions will be referred to herein as "Type A," "Type B," "Type C" and "Type E" reorganizations respectively.

Neither the Code nor the regulations define what is meant by a "plan." While a number of cases make it clear that the plan need not be reduced to writing,[10] the safest practice is to prepare a written document setting forth the steps of the plan, which can be submitted to the Board of Directors of the two companies for approval. A "plan of merger" under state corporation laws would no doubt constitute a "plan of reorganization." Where the terms of the transaction are embodied in an agreement or contract between two corporations or between the acquiring corporation and the stockholders of the acquired corporation, it may be advisable to give this instrument a title such as "Agreement and Plan of Reorganization" and to include a recital stating that the agreement is intended to constitute a plan of reorganization under the Internal Revenue Code.

Let us consider, first, the practical alternatives available to Mr. Able of effecting a "stock" exchange under Section 354. Section 354 itself imposes no restrictions on the types of "stock or securities" which Mr. Able may receive tax-free from Company X in exchange for his stock of Company A. The term "securities," although not defined in the Code or Regulations, refers to debt securities, as distinguished from stock. However, it refers only to long-term debt securities, such as corporate bonds and debentures, and does not include

[10] C. T. Investment Co. v. Commissioner, 88 F.2d 582 (8th Cir. 1937); Redfield, 34 B.T.A. 967, 973 (1936); Murrin, 24 T.C. 502 (1955); and Transport Products Corp. v. Commissioner, 25 T.C. 853 (1956), *affirmed* 239 F.2d 859 (6th Cir. 1956).

short-term notes.[11] However, if Mr. Able receives "securities" of Company X, without surrendering "securities" of Company A, or receives a greater principal amount of "securities" than he surrenders, gain on the exchange is taxable, but only to the extent of the excess principal amount of securities received over securities surrendered.[12] There are no limitations in Section 354 as to the kind of stock which Mr. Able may receive. The stock may be common or preferred, voting or non-voting.[13] It may be a stock held generally by the public, or it may be a specially created class of stock tailored to meet the needs of the particular transaction.

Section 356 modifies Section 354 by providing that if a transaction would qualify under Section 354, but for the fact that property other than stock or securities is received, gain will be recognized, but only to the extent of such other property (generally referred to as "boot").[14] "Boot" may be taxed as a dividend if it has the effect of a dividend.[15] Section 356 imposes no limitation on the amount or proportion of "boot" received by the transferor in a "partially tax-free" exchange (that is, an exchange taxable only to the extent of the "boot").[16] The word "solely" as used in Section 354 is thus only important if it is intended to keep a proposed exchange completely tax-free.

In order for Section 354 to apply, the exchange transaction must fit one of the statutory definitions of "reorganization." Turning to Section 368(a)(1), it will be observed that either a Type A or Type B transaction can be used to meet the requirement that an exchange be made pursuant to a plan of reorganization.

The Type A transaction, a statutory merger or consolidation, offers a simple method of meeting the requirements of both Section 354 and Section 368. The simplest procedure would be to merge Company A into Company X under applicable state corporation statutes. Pursuant to a plan of merger, Mr. Able could surrender his common stock of Company A and receive in exchange common stock of Company X. However, under a Type A merger, the parties are not restricted to this simple type of exchange. Section 368(a)(1)(A) places no limitations on the broad latitude available under Section 354 as to the types of stock or securities Mr. Able may receive in the merger. As a conse-

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11 Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462 (1933) (notes up to 3½ months); Neville Coke & Chemical Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), *cert. den.* 326 U.S. 726 (1945) (three, four and five-year notes). Ten-year notes were held to be "securities" in Burnham v. Commissioner, 86 F.2d 776 (7th Cir. 1936), *cert. den.* 300 U.S. 683 (1937).

12 See §§354(a)(2), 354(a)(3) and 356.

13 But see below, page 415 for discussion of whether preferred stock received in an exchange constitutes "Section 306 stock."

14 §356(a)(1).

15 §356(a)(2).

16 Of course, if the proportion of 'boot" is too great, a point may be reached where the "continuity of interest" requirement is not met.

quence, a statutory merger permits the tax-free receipt of many kinds of securities which would destroy the tax-free character of a transaction under another definition of reorganization. If the applicable merger statutes permit, it is possible, for example, for Mr. Able to receive not only ordinary common stock, but also non-voting common stock, voting preferred stock, non-voting preferred stock, convertible preferred stock, or any other type of stock or combination of types which may fit the needs of a particular situation.[16a] A statutory merger is a Type A reorganization even if the plan of merger permits a transferor to receive partly cash and partly stock or partly notes and partly stock. Such an exchange is tax-free to the extent of the stock received, although the cash or notes would be taxable as "boot."

It has been assumed in the example stated, that Mr. Able is the sole stockholder of Company A. However, if there were a minority stockholder who wanted cash instead of stock of Company X, the plan of merger could provide (if permitted by the state merger statute) for distribution of cash to the minority stockholder, but stock and only stock to Mr. Able. Under such circumstances, the minority holder would, of course, be taxed, but without jeopardizing the tax-free character of the exchange to Mr. Able. Whenever a stockholder of the merger corporation receives cash, notes or other property than stock or securities of the surviving corporation, care must be taken to assure compliance with the "continuity of interest" rule. For this reason, the securing of a ruling may be advisable whenever a substantial amount of cash or other property is distributed in a statutory merger. A partial distribution in cash or notes under a statutory merger would not ordinarily be attractive to Company X, since there is doubt whether it would receive any additional basis in the property acquired for the cash or notes paid.[17]

The pending proposal for revision of Section 368 would require, by specific statutory provision, that 66⅔% of consideration received consist of stock of the acquiring corporation in order for a merger or consolidation to qualify as a Type A reorganization.[18] "Boot" exceeding one-third of the total consideration would make the entire gain on the transaction fully taxable. The effect of such a revision would be to codify the "continuity of interest" rule in terms of a specific mathematical formula.

While the Type A transaction provides a simple solution from the point of view of Mr. Able and Company A, Company X may not find the Type A transaction feasible from its viewpoint. A merger would

[16a] But see page 414 below for general discussion of effect of Section 306 on receipt of preferred stock.

[17] Schweitzer & Conrad, Inc., 41 B.T.A. 533 (1940); Muskegon Motor Specialties Co., 45 B.T.A. 551 (1944).

[18] §26, H.R. 4459, 86th Cong., 1st Sess.

require Company X to assume the liabilities of Company A. This may be unacceptable to Company X, particularly if Company A is likely to have substantial contingent liabilities such as damage suits or potential income tax deficiencies. Moreover, a statutory merger generally contemplates a shareholder vote of both corporations. While this is a simple matter in Company A, where Mr. Able is the only holder, it may present serious problems to Company X, particularly if it is a large, publicly-held company. The calling of a special meeting of stockholders may be expensive and inconvenient and may arouse stockholder antagonism. The applicable state merger statute may also give stockholders of Company X the right to dissent from the merger and claim the fair value of their shares in cash.[19] If the stock of Company X is listed on an exchange, solicitation of proxies under the rules prescribed by the Securities and Exchange Commission will be required.[20] For these reasons, Company X may insist that the acquisition be accomplished by some other method.

An alternative type of exchange qualifying under Section 354 is a Type B reorganization, an exchange of at least 80% of Mr. Able's stock in Company A solely for voting stock of Company X. While many transactions could be handled as either Type A or Type B reorganizations, there are a number of important variations between the two methods. State corporation laws generally will not require a vote of the shareholders of Company X to approve a Type B transaction assuming it has sufficient authorized, but unissued, capital to effect the exchange. However, if stock of Company X is listed on a securities exchange, such a vote might be required by the rules of the exchange.[21] Following a Type B exchange, Company X may either liquidate Company A or keep it alive as a subsidiary. In a Type B transaction, Mr. Able may keep up to 20% of his stock and receive Company X stock for the balance, so that after the exchange Company A would operate as a subsidiary (but not wholly-owned) of Company X.

Assuming that Company X insists on acquiring all of the stock of Company A, as is usually the case, the Type B transaction could present difficulties if there were minority shareholders of Company A who opposed the transaction. In a Type A (merger) transaction and, as we shall see, in a Type C (asset) transaction, state corporation statutes generally make it possible to compel 100% participation in a reorganization by the vote of a requisite majority of shareholders. In a Type B exchange, such participation can be secured only by the separate agree-

[19] See, for example, Wis. Stat. §180.69.
[20] §14(a), Securities and Exchange Act of 1934, and Regulation X-14 thereunder.
[21] The rules of the New York Stock Exchange, for example, require a shareholder vote and proxy solicitation if the shares to be issued on the exchange will increase the outstanding shares by 20%. See New York Stock Exchange Company Manual, p. B-17.

ment of each shareholder. The Type B transaction is generally evidenced by a written agreement or contract, executed by the transferee corporation and by each individual shareholder of the corporation which is being acquired. The larger the number of shareholders in this corporation, the more difficult it becomes to obtain unanimous agreement. Moreover, the Type B transaction might present greater difficulties to the acquiring corporation insofar as the Securities Act of 1933 and state securities laws are concerned.[22]

One of the most troublesome features of the Type B transaction is the requirement of Section 368(a)(1)(B) that the exchange be *solely* for *voting* stock in order to qualify as a reorganization. Suppose, for example, Mr. Able exchanges all of his stock for voting stock in Company X plus $50,000. The question immediately arises whether the entire transaction is taxable, since the transaction fails to meet the definition of reorganization, or whether the exchange of stock is partially tax-free with the taxable gain being limited, pursuant to Section 356, to the cash "boot" received.

The Internal Revenue Service has taken the position that requirement of Section 368 that a Type B exchange be "solely" for stock is not overridden by the "boot" provisions of Section 356.[23] It contends that one cannot apply Section 356 until the transaction has first qualified as a reorganization under Section 368(a)(1)(B). The position of the Service has recently been refuted by the Seventh Circuit and the Tax Court, both of which have limited the taxable gain to the "boot" where the transfer would qualify as a Type B exchange but for the cash received.[24]

If the bill now pending before Congress is enacted in its present form, the Type B transaction will require only that 66⅔% of the consideration received in the exchange be stock with the balance, if any, being taxed as "boot."[25] Section 356 would be amended, however, to reverse the recent court decisions by providing that the "boot" provisions are applicable to a Type B transaction only if the definition of reorganization is first met.[26]

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[22] Rule 133 of the Securities and Exchange Commission excludes Type A and Type C transactions from the definition of "sale"' where complete participation is required by a requisite vote. The Rule does not apply to Type B transactions, which means the acquiring corporation may need to register the securities which it issues in the exchange, unless the transaction can be brought within the "private offering" exemption in §4(1) of the Securities Act. In order to make this exemption available, Company X may insist that as part of the agreement, Mr. Able agree to sign a covenant that he is acquiring the securities of Company X for investment and not with a view to distribution.

[23] Rev. Rul. 56-184, 1956-1 C.B. 190. The Service earlier had taken a contrary position. See, for example, Reg. 118, §39.112(g)-4.

[24] Turnbow, 32 T.C. #57 (1959) and Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1957), *reversing* 24 T.C. 792 (1955).

[25] Proposed amendment to §368(a)(1)(B), §26, H.R. 4459, 86th Cong.

[26] Proposed amendment to §356(a)(1)(A), §21, H.R. 4459 86th Cong.

It is sometimes difficult to determine whether consideration other than voting stock has been received. In the illustration, for example, would the transaction be jeopardized by the occurrence of any of the following at or about the time of the exchange: (a) Mr. Able's receiving a three-year contract of employment from Company X; (b) Mr. Able's receiving a cash payment in consideration of his giving a covenant not to compete with Company X for a period of years; (c) Mr. Able's entering into an agreement for the leasing of property or licensing or patents to Company X; (d) Mr. Able's receiving options or warrants to acquire additional stock in Company X; (e) Payment of Mr. Able's legal expenses in connection with the exchange by either Company A or Company X; and (f) Payment of a dividend by Company A just prior to the exchange. Presumably, no difficulty would be encountered with the employment contract, the covenant not to compete, or the lease or patent license, but only if the arrangement is a real one and the consideration is reasonable. The Internal Revenue Service must be satisfied that an employment arrangement is not just a sham designated to secure tax deductions for Company for what in reality are installment payments to Mr. Able for the purchase of his stock. On the other hand, the stock option seems clearly to be "other property" taxable as "boot."[29] Payment of legal expenses by Company X would well jeopardize the tax-free character of the transaction, particularly if the Internal Revenue Service should be successful in overturning the *Howard* case. On the other hand, payment of such expenses by Company A, just prior to the closing, would probably not have this drastic effect, although the payment would in all likelihood be claimed to be a dividend paid by Company A to Mr. Able. A dividend paid by Company A just prior to closing would be taxable to Mr. Able as such, but should have adverse effect on the tax-free character of the exchange.[28]

One final distinction between Type A and Type B exchanges should be mentioned. In a Type B exchange, Mr. Able must receive *voting* stock in order to meet the definition of a reorganization under Section 368. As we have seen, this is not required to qualify as a Type A reorganization. In a Type B exchange, the stock issued by the acquiring corporation may, of course, be preferred stock, if it carries voting rights. The relative strength of these voting rights may be limited through use of a high par value preferred stock.[29] The extent to which

[27] Reg. §1.354-1 holds that for purposes of Section 354, stock rights and stock warrants are not included in the term "stock or securities."

[28] Rev. Rul. 56-184, 1956-1 C.B. 190.

[29] Assume, for example, that the consideration to be received by Mr. Able on the exchange is $100,000 worth of Company X common stock, which has a market value of $10 per share. Mr. Able would receive 10,000 shares and 10,000 votes. If, on the other hand, he receives the same $100,000 value, but

[redacted]

change is solely for voting stock, the assumption of liabilities of Company A by Company X is disregarded. Section 368(a)(1)(C) is modified by Section 368(a)(2)(B) which, in effect, permits Company X to pay up to 20% of the total purchase price in "other property" (*e.g.*, cash or notes). For purposes of this 20% test, however, liabilities assumed must be treated as "other property." Thus, if liabilities assumed by Company X are in excess of 20% of the total price, nó cash or other "boot" can be received by Company A. Under Section 361(b), taxable gain on the Type C exchange is limited to the "boot" received.

A Type C exchange will usually require the vote of shareholders of Company A under state statutes requiring a shareholder vote on both a sale of substantially all of the assets of a corporation, and on a liquidation. A Type C exchange will not require a shareholder vote in Company X unless it necessitates an increase in authorized capital or unless a vote is required by stock exchange rules.[31a]

The exchange must be for "substantially" all the assets of Company A. As a general rule of thumb, the Internal Revenue Service is known to 90% or more as meeting the "substantially all" test.[32] However, the determination may to some extent depend on the nature of the assets retained. Retention of cash, for example, is not as serious as retention of operating assets which might interfere with the continued operation by Company X of the business previously operated by Company A. If only cash is retained, a transaction may be approved where the assets transferred are less than 90% of the total.[33] The securing of a ruling is recommended whenever assets retained exceed 10% of the total, or include operating assets.

In a normal Type C reorganization, the acquiring corporation assumes all the known liabilities of the acquired corporation. Unknown or undisclosed liabilities present no particular problems in Type C exchanges, since the acquiring corporation is responsible only for those liabilities which it expressly assumes under the reorganization agreement. The only assets normally retained by the acquired corporation will be a sufficient amount of cash to pay its expenses incident to the exchange and liquidation, including fees of its attorneys.

[31a] See note 21 *supra*.

[32] Exchanges were held to meet the "substantially all" test in Britt v. Commissioner, 114 F.2d 10 (4th Cir. 1940) (92% of assets); Western Industries Co. v. Helvering, 82 F.2d 461 (D.C. Cir. 1936) (85.2% of assets); and Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932) (91.5% of assets). On the other hand, two-thirds of the assets did not qualify in Pillar Rock Packing Co. v. Commissioner, 90 F.2d 949 (9th Cir. 1949), nor did 75% in I.T. 2373, VI-2 C.B. 19 (1927).

[33] See, for example, Rev. Rul. 57-518, 1957-2 C.B. 253, in which a transaction was held to qualify as a Type C reorganization where only 70% of assets were transferred, but where the retained assets consisted of cash, accounts receivable and notes, and three per cent of total inventory. I.T. 2373, cited in note 32 *supra*, was distinguished on the ground that the 25% of assets retained in that case were operating assets.

As previously indicated, state corporation laws generally require favorable two-thirds vote of the shareholders of a corporation to authorize a sale or exchange of substantially all its assets, as well as to authorize its liquidation.[34] This, of course, presents no problem in the case of Company A, since Mr. Able is the sole shareholder, but can present problems where there are substantial minority shareholders. Such problems may be magnified where state statutes require the corporation, at the election of shareholders dissenting from a sale, to purchase dissenters' shares at a fair value determined by a court.[35] Dissenters from a sale or exchange of corporate assets are frequently denied buy-outrights where the sale of assets is made in connection with the liquidation of the corporation.[36] Under such statutes, it can be argued that the buy-out rights are not applicable to a Type C reorganization. However, in at least one state, it has been held that a Type C transaction was, in effect, a merger. It ruled that dissenters' rights to demand a buy-out, although not available under the sale of assets statute since the case involved the *acquiring* corporation, were required by the merger statute.[37] Substantial demands by dissenters, if upheld by a court, could seriously impair the cash position of the selling corporation, and even more serious, might require retention of an amount of cash so large that the exchange would not meet the "substantially all" test. Where there are minority shareholders, the agreement between two corporations for a Type C reorganization will normally provide that at the election of either party, the exchange may be avoided in the event of the exercise of dissenters' rights by more than a specified percentage (such as 5%) of shareholders of the acquired corporation.

In summary, Mr. Able and Company X will find at least three types of tax-free reorganization available whereby Company X can acquie the business of Company A. The statutory merger and the "stock" exchange are, from the practitioner's point of view, generally simpler to handle. The third type, the "assets" exchange involves a more complicated agreement between the parties because of the necessity of fully describing the assets acquired and liabilities assumed. On the other hand, the "asset" exchange insulates the acquiring corporation from unknown and undisclosed liabilities. The choice between types of reorganization will depend not only on tax considerations,

[34] See, for example, Wis. Stat. §180.71 as to the sale of assets and §180.761 as to dissolution.

[35] See, for example, Wis. Stat. §180.72.

[36] See, Wis. Stat. §180.72(1).

[37] Farris v. Glen Alden Corporation, 393 Pa. 427, 143 A.2d 25 (1958). The decision may be explained by the rather unique facts of the case. The acquiring corporation was considerably smaller than the acquired corporation, and the two corporations were engaged in completely different businesses. The practical effect of the reorganization was to effect an almost complete change in the nature of the shareholders' investment.

but on many other factors as well, such as shareholder voting rights, stock exchange rules, requirements of state and federal securities laws, and practical problems of negotiation.

Mr. Baker's Problem—Acquisition by Minority Holders

We turn now to the entirely different type of problem faced by Mr. Baker. Mr. Baker is not negotiating with an outsider who desires to acquire his business, but only with his own sons, who are already minority shareholders. The logical method for Mr. Baker to transfer control of Company B to his sons, without making gifts of stock and without requiring cash payments from his sons, is to exchange his common stock for a non-voting preferred stock of Company B. How can such an exchange be qualified as a tax-free exchange?

Section 354, in addition to permitting a tax-free exchange of securities between two corporations, also provides that an exchange of stock or securities in a corporation for other stock or securities of the *same* corporation is tax free if made in pursuance of a plan of reorganization. Once again, therefore, the definitions of reorganization must be examined. Section 368(a)(1)(E) defines a reorganization simply as a "recapitalization." The term "recapitalization" is not defined in the Internal Revenue Code, nor in the regulations under Section 368. However, the regulations give a number of examples of transactions constituting recapitalizations, one of which states that a recapitalization occurs if "a corporation issues preferred stock, previously authorized but unissued, for outstanding common stock."[38] On its fact, then, the exchange of Mr. Baker's common stock for preferred stock of Company B meets the statutory test of a tax-free reorganization.

Mr. Baker must proceed with caution, however. In a Type E transaction, special attention must be given to the "business purpose" test. In Type A, B and C reorganizations, the business purpose is generally satisfied by the anticipated benefits from the combination of two previously separate business organizations. In a Type E transaction, no combination of enterprises is involved, and there is no change in the nature of the business conducted. There is a potential hazard that the Internal Revenue Service may claim that the exchange accomplished no corporate business purpose but rather was entered into for the personal convenience of the individual shareholders.

Fortunately, transactions of the type contemplated by Mr. Baker, fit a pattern which has on a number of occasions held to have a business purpose. This business purpose is found in the benefits to be derived from the encouragement and incentive given to younger executives and the placing of voting control of the company into the hands

[38] Reg. §1.368-2(e)(3).

of the active management. In spite of the relatively large number of favorable cases and rulings dealing with transactions of this type,[39] it is advisable for Mr. Baker to secure a favorable tax ruling on the proposed transaction before proceeding, unless his facts are completely on all fours with a previously published ruling.

Even with a favorable ruling on the recapitalization, there may be other problems to be considered by Mr. Baker, which will not be solved by the ruling. It can be anticipated that the ruling letter will expressly reserve any opinion as to whether there has been a gift from Mr. Baker to his sons, or payment of compensation to the sons.[39a] To reduce the risk of difficulties on these questions on subsequent audit, extreme care must be exercised in fixing the rate of exchange between the common stock being retired and the preferred stock being issued. If the value of the preferred stock is subsequently determined to have been less than the common stock which is retired, it may be claimed that a taxable gift was made by Mr. Baker to his sons to the extent of the difference in values, or that taxable compensation was received by the sons. The Internal Revenue Service will not ordinarily issue rulings with respect to the market value of stock or other property.[40] As a precaution, the advice of an expert should be obtained on the relative values of the stock surrendered and the stock received, and in doubtful cases, a record should be made for the future by obtaining a formal expert appraisal.

Effect of Section 306 on Reorganizations

Whenever preferred stock is received in a reorganization, consideration must be given to the effect of Section 306. This is true regardless of the type of reorganization and regardless of whether it involves two corporations (as in Mr. Able's case) or one corporation (as in Mr. Baker's case).

Section 306 of the Code defines, for tax purposes, a new category of securities known as "Section 306 stock." "Section 306 stock" is defined by Section 306(c), in general, as preferred stock which is either (1) received as a stock dividend; (2) received in a tax-free reorganization but only to the extent that the effect of the transaction was substantially the same as receipt of a stock dividend; or (3) received in exchange for other Section 306 stock. Section 306(a) provides that upon the subsequent disposition of Section 306 stock, the general rule is that the entire proceeds are taxable as ordinary income. There are exceptions to the general rule which are provided for in Section

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[39] Rev. Rul. 54-13, 1954-1 C.B. 109; Rev. Rul. 59-84, 1959-1 C.B. 71; Wolf Envelope Co. 17 T.C. 471 (1951); Hartzell, 40 B.T.A. 492 (1939); and Dean 10 T.C. 19 (1948).

[39a] See, for example, Rev. Rul. 54-13, 1954-1 C.B. 109.

[40] Reg. §601.201(e).

306(b). Thus, even though stock is "Section 306 stock" Section 306(a) is not applicable if (1) the disposition terminates the shareholders' interest in the corporation, (2) if the stock is redeemed in partial or complete liquidation; (3) if the disposition is a tax-free exchange; and (4) if it is established to the satisfaction of the Commissioner that the disposition was "not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax."

Applying these rules to the examples previously discussed, if Mr. Able receives both common stock and preferred stock of Company X in the reorganization (regardless of whether the reorganization is Type A, Type B or Type C), the preferred stock will be Section 306 stock.[41] However, if tax-saving is not the principal purpose of the issuance of preferred stock, the proceeds of a sale will not be treated as ordinary income. The chances are good of securing a favorable ruling if the corporation issuing the preferred stock is a large publicly-held corporation and if there is no intention with respect to the redemption of the preferred stock at the time of issuance.[42] Thus, hazards of Section 306 can be avoided by Mr. Able in an appropriate fact situation.

In Mr. Baker's case, the preferred stock received by him in exchange for his common stock will not ordinarily be Section 306 stock if all of his common stock is exchanged for preferred stock, but will be Section 306 stock if he retains a portion of his common stock.[43]

In appropriate circumstances, Mr. Able and Mr. Baker may be willing to accept preferred stock in a reorganization, even though it is clear that such stock is Section 306 stock. If, for example, they intend to hold the preferred stock for their remaining lifetime, Section 306 presents no real problem, since the stock loses the "taint" of Section 306 when it passes through their estates.[44] It should be noted, however, that the same is not true of Section 306 stock passing by inter vivos gift, which retains its characteristics in the hands of the donee.[45]

Conclusion

The foregoing review of the procedures and problems involved in tax-free exchanges has been undertaken primarily from the transferor's point of view. However, since reorganizations will nearly always be the subject of arms' length negotiations, the transferor cannot completely ignore the consequences of the transferee if he intends to

[41] Reg. §1.306-3(d), Example 1; Rev. Rul. 56-116, 1956-1 C.B. 164; Rev. Rul. 57-103, 1957-1 C.B. 113.
[42] Rev. Rul. 56-116, 1956-1 C.B. 164; Rev. Rul. 57-103, 1957-1 C.B. 113; Rev. Rul. 57-212, 1957-1 C.B. 114.
[43] Rev. Rul. 59-84, 1959-1 C.B. 71.
[44] Reg. §1.306-3(e).
[45] *Ibid.*

reach an agreement. The necessity of fitting a particular transaction into the appropriate classifications under the income tax laws, as well as the securities law, may present difficult problems of negotiation, but these should rarely be insurmountable. The time spent and difficulties encountered in negotiating a tax-free reorganization may be recovered many times over in taxes saved or postponed. The possibility of negotiating a proposed sale of business, whatever its size, as a tax-free reorganization should therefore never be overlooked. While there will be cases in which a reorganization is not appropriate, the tax savings will often be so great that no other course can be seriously considered.