Some Tax Considerations Affecting the Design of a Chapter X Reorganization

Don S. Harnack
SOME TAX CONSIDERATIONS AFFECTING THE DESIGN OF A CHAPTER X REORGANIZATION

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This discussion shall point out the inconsistent tax treatment afforded varying kinds of Chapter X insolvency reorganizations under the present Internal Revenue Code.

By looking to the applicable sections of the Bankruptcy Act, their effort upon a reorganization, and the inter-relation of the bankruptcy statutes and the taxing statutes, it will be possible to recognize and appraise some of the problems that must be taken into consideration by any party contemplating an insolvency reorganization.

Application of Section 112(b)(10)² of the Internal Revenue Code to Chapter X reorganization turns upon the form that the reorganization takes. The terms of Section 112(b)(10) limit it to those reorganizations that make use of a transfer of property to some other corporation. The section does not apply to a reorganization accomplished by an internal structural change, whereby the corporation outwardly maintains the same corporate entity. This latter type of reorganization shall be referred to as a recapitalization.

It is hoped that, after viewing the variable treatment accorded these two types of reorganizations, it will be evident that statutory changes are necessary in this area.

APPLICATION OF THE BANKRUPTCY ACT

A primary purpose of Section 77B³, and its subsequent refinement in Chapter X of the National Bankruptcy Act as amended in 1938, was to furnish insolvent corporations greater opportunity to revive through reorganization. It was hoped that greater flexibility in the reorganization sections of Chapter X would help lessen the number of absolute failures, thereby minimizing the disruptive effect of a business recession upon the entire national economy.

Chapter X incorporates, with numerous changes and additions, former Section 77B of the National Bankruptcy Act. Those additions of primary importance for the purpose of this discussion are Sections 268⁴ and 270⁵. It was intended by the enactment of Section 268 to

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²Int. Rev. Code §112(b)(10).
avoid taxing the debtor corporation upon the gain arising from a modification in, or cancellation of, any indebtedness resulting under a Chapter X proceeding, aiming particularly at avoiding those tax assessments predicated upon the doctrine of *United States v. Kirby Lumber Co.*. Mr. Banks, the party primarily responsible for the drafting of Section 268 and its inclusion in the legislation, had two immediate motivations. He desired to avoid the heavy tax levy which otherwise might follow immediately upon reorganization because of a scaling down of liabilities. Also, he felt a concept that would make creditors' forgiveness subject debtors to a tax upon their 'de facto' property, "was repugnant to common sense and justice." The treasury insisted upon the adoption of Section 270 to qualify Section 268 so as to obviate the use of a Chapter X reorganization for tax avoidance, but the necessity of Section 270 for this purpose is questionable because of the protection afforded by Section 269. This section could independently furnish the Treasury Department adequate protection against the use of a Chapter X plan for tax avoidance. Section 269 allows objection to the plans confirmation by the treasury if one of its principal purposes is the avoidance of taxes. In practice, this section is rarely used.

As enacted in 1938, Section 270 provided in essence for the reduction of the tax basis of the transferee's assets, by that amount which would equal the amount by which the indebtedness of the transferor had been reduced or cancelled. In the case of a recapitalization the basis of the assets retained by the corporation were reduced by the above amount. It was possible, through a literal application of Section 270, to end up after an insolvency reorganization with the transferee corporation or recapitalized corporation having a basis on its assets of less than zero. The obvious effect of this section was the negation of any permanent tax advantage previously conferred by Section 268. The reduction of basis had an immediate effect upon the income of the reorganized corporation. The question also arose as to whether Section 270 was to be applicable only in conjunction with Section 268, or would operate independently of any finding of tax benefit under Section 268. The amendment of Section 270 in 1940 was to be retroactive to June 22, 1938. For a brief comment on the results of this

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6 284 U.S. 1 (1931).
7 Mr. Banks discusses his part in the enactment of these sections in a discussion carried on by the Chicago Bar Association. See *Bankruptcy Committee of Chicago Bar Association Discusses Section 270, Chapter X of the Chandler Act*, A 5 Corp. Reorg. 236, 240 (1943).
8 *Ibid.* at 239.
11 54 STAT. 709 (1940), 11 U.S.C. §670 (1946). The amendment was to be retroactive to June 22, 1938. For a brief comment on the results of this
lessened its impact by placing a "floor" beneath the possible reduction of the reorganized corporation's basis: not less than the fair market value of the property in question, calculated as of the date of the insolvency reorganization plan's confirmation.

As amended, Section 270 continued to operate to the substantial financial disadvantage of various reorganized corporations. The following example is not typical. Z. corporation went through a tax free reorganization before the passage of Section 270. The future earning power of Z was predicated in part upon the predicted amount of depreciation available, calculated on the assumption that Z would have the same basis as its transferor. The purpose of Z in obtaining the tax free reorganization was its desire to retain the original basis of $5,000,000. Applying Section 270, the treasury estimated the fair market value at the time of the transaction to have been $2,500,000. Assuming a depreciation rate of 5% and a corporate income tax rate of 40%, the application of Section 270 reduced the annual income of Z by $50,000. The reduced basis also can often have the collateral effect of lessening the likelihood of the future transfer of the property, this being especially true when the market value fixed by the treasury is determined during a period of economic stress. This reduction of income means that the original equity interests have even less chance of maintaining any interest in the reorganized corporation.

Another highly objectionable result of Section 270 is that it leaves the fair market valuation in abeyance. Although the valuation is based upon the value of the property as of the date of final approval of the plan of reorganization, the determination is to be made subsequent to this approval by the Treasury Department. The plan must be approved by the Bankruptcy Court without the inclusion of the depreciation basis. It is strongly suggested that this determination should be made during the formulation of the plan and by the bankruptcy Court, whose acquiescence is requisite for approval of the plan. It is difficult to perceive a completely satisfactory plan of reorganization with so fundamental an item as the depreciation basis undetermined. It would not jeopardize the interests of the Treasury to at least require a determination of value at such time as to prove of some value in the formulation of the plan of reorganization. But this final suggestion would require a change in Section 270.

attempt see, Hanna and MacLachlin, The Bankruptcy Act of 1898 as Amended, 4th ed. 222, 224 (1951).

12 A5 Corp. Reorg. 236, 239 (1943).

13 54 Stat. 709 (1940), 11 U.S.C. §670 (1946), "The Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury, shall prescribe such regulations as he may deem necessary in order to reflect such decrease in basis for Federal income tax purposes and otherwise carry into effect the purposes of this section."
The enactment of Sections 112(b)(10) and 113(a)(22),14 read in conjunction with Section 112(1),15 relieve those reorganizations that qualify within the wording of the statute from the operation of Section 270. The new corporation takes the insolvent’s assets at the insolvent’s basis. Similarly Section 112(1)16 provides that no gain or loss is recognized to those security holders of the solvent corporation, who exchange their securities on the insolvent corporation for those of the reorganized corporation.

A corporation, in order to qualify under Section 112(b)(10), must be in receivership, foreclosure or similar proceedings, or in a proceeding under Chapter X or former Section 77B. There must be a transfer of property by the corporation pursuant to a court order. The transfer must be to another corporation, but only to one organized or made use of to effectuate a plan of reorganization approved by the court.17 The transfer must also be made in exchange “solely for stock or securities” in the transferee corporation, subject to the provisions of Sections 112(d) and 112(k). The definition of reorganization found in Section 112(g) is not applicable. It is necessary to look to Section 112(b)(10) for the definition of reorganization that is to be applied. While the new definition is enlarged and meant to allow greater flexibility in the drawing up of reorganization plans, it remains bound by the judicial18 qualifications applicable to Section 112(g) reorganizations. It is to be noted that this tax provision does not cover a large part of the reorganization field encompassed by Chapter X. By the terms of Section 112(b)(10), utilization of another corporate entity is mandatory. This requirement necessarily and purposely excludes19 any reorganization consummated by an adjustment of the capital and debt structure of the insolvent corporation without a transfer of prop-

14 Int. Rev. Code §113(a) (22). The basis provision for §112(b)(10).
15 Added to the Code by §121(b) of the Revenue Act of 1943.
16 For a discussion of the effect of §112(1) see, Pacific Public Service Co. v. Comm'r., 4 T.C. 742 (1944).
17 A Chapter X Petition will be approved only if the Bankruptcy Court is satisfied “that the corporation is insolvent or unable to pay its debts as they mature.” 52 Stat. 886 (1938), 11 U.S.C. §530 (1946).
18 H. R. Rep. No. 1079, 78th Cong., 2d Sess. 46 (1944). “It is intended, however, that only an actual reorganization of a corporation will be covered as distinguished from a liquidation in a bankruptcy proceeding and sale of property to either new or old interests supplying new capital and discharging the obligations of the old corporation. It is also intended that the business purpose test enunciated in Gregory v. Helvering (293 U.S. 465), shall likewise apply to transactions under these amendments.”; For reorganizations that do not qualify, cf. Mascot Stove Co. v. Commissioner, 120 F. (2d) 153 (6th Cir. 1941); Templeton’s Jewelers, Inc. v. U.S. 126 F. (2d) 251 (6th Cir. 1942); Chicago Stadium Co. v. Commissioner, 13 T.C. 889 (1949); Harbor Building Trust v. Commissioner, 16 T.C. 1321 (1951).
19 Ibid. “This amendment has no application to reorganizations consummated by adjustment of the capital or debt structure of the insolvent corporation without the transfer of its assets to another corporation.”
erty "to another corporation organized or made use of." The limited coverage of Section 112(b)(10) results in the following dissimilarities.

The basis provision, Section 113(a)(22), enacted to complement Section 112(b)(10), provides that if the property was acquired by the corporation as a party to a reorganization qualifying under Section 112(b)(10). Section 270 of the Bankruptcy Act will have no effect. The application of this Section to a Chapter X reorganization results in the insolvent corporation finally receiving the benefit originally intended to be conferred by Section 268. But, because of the limited application of Section 112(b)(10), Section 270 still applies to those Chapter X reorganizations that are cast in form of a recapitalization. Provision originally was made for recapitalizations in the Senate draft of the Revenue Act of 1943.\textsuperscript{20} The section proposed was comparable to the present Section 112(b)(10). It was dropped without explanation in the Conference Committee, but Section 113(b)(4) was added to avoid the application of Section 270 to those recapitalizations begun under Section 77B and having a final judgment or decree entered prior to September 22, 1938.

In practice, the judicial interpretation of Section 270 has minimized the tax discrimination between reorganizations and recapitalizations. To determine the direction and remaining impact of Section 270, it is necessary to examine the judicial construction of the terms "Cancellation and reduction." It was the intention of one of the participating draftsmen of this legislation\textsuperscript{24} that these terms receive a narrow construction. A debt is not to be considered cancelled unless the

\textsuperscript{20} Revenue Act of 1943, Successive Drafts and Reports; (SEN. REP. No. 3687, 78th Cong., 2d. Sess. 54 (1943). Passed by Senate; (33) Sec. (115)\textsuperscript{52}) Reorganization by Adjustment of Capital and Debt Structure of an Existing Corporation.

"If the reorganization of a corporation (other than a railroad corporation as defined in Section 77M of the National Bankruptcy Act, as amended) in a receivership proceeding or in a proceeding under Section 77B of Chapter X of the National Bankruptcy Act, as amended, is consummated under a plan by adjustment of the capital and debt structure of an existing corporation rather than by a transfer of the assets to a successor corporation, then, at the election of the Taxpayer notwithstanding the provisions of Section 270 of the National Bankruptcy Act, as amended, the basis of such assets shall be the same as immediately prior to the reorganization and for the purposes of Sections 718 and 760, the reorganized corporation shall be treated as if it were a corporation which acquired the assets pursuant to a plan of reorganization, in exchange for the stock and securities and an assumption of the liabilities of such corporation as reorganized. This paragraph shall not apply if any of the persons who were shareholders of the corporation immediately before the reorganization are shareholders of the corporation immediately after the reorganization by reason of a continuing equity in the assets of the corporation attributable to such shareholders solely by reason of their ownership of stock. The term 'reorganization,' as used in this paragraph, shall not be limited by the definition of such term in Section 112(g)."

"The election under this section shall be made under such rules and regulations as the Commissioner, with the approval of the Secretary, shall prescribe."

\textsuperscript{24} Mr. Banks, A5 Corp. Reorg. 236, 242 (1943).
creditors are left with nothing in its stead. Applying this intended construction to an exchange of bonds for other securities, for instance stock, the transfer would not result in a debt reduction or cancellation, but rather a change in the form of claim retained by the creditor. The Commissioner of Internal Revenue took a much narrower view of these terms. Before the passage of Section 270, the Commissioner had already contended, in Commissioner v. Capento Securities Corp.,22 that when the corporation, during the taxable year, received back and cancelled it bonds with a face value of $500,000 in exchange for the issuance of its preferred stock worth only $50,000, the corporation realized a taxable gain of $450,000. The court dismissed the commissioner's argument on two grounds: that this transaction fell under Section 112(b)(3), therefore no gain or loss was recognizable; and that the transaction produced no income chargeable to the corporation. Admittedly, there was a discharge of liability but at the same time a new capital stock interest was created which became a balance sheet liability. The court found no present realization of income arising from the transaction. The Tax Court, in Alcasa Hotel Inc.,23 extended this principal to the exchange of common stock for mortgage notes and accumulated interest. In Commissioner v. Motor Mart Trust,24 the court asserted that the exchange of stock for bonds did not fall within the meaning of cancellation, but rather the transaction could be considered merely a substitution of common stock for bonds in a reorganization proceeding. The Tax Court, in Tower Bldg. Corp.,25 said:

"In the instant case we likewise hold that the exchange of the petitioner's new stock for its first and second mortgage bonds, unsecured claims, and old stock in accordance with a plan approved in the 77B proceeding did not amount to a cancellation or reduction of indebtedness under Section 270 of the Bankruptcy Act, as amended."

This decision would appear to affirm the Motor Mart doctrine sufficiently so as to allow the use of recapitalizations when practical, without undue concern for the application of Section 270. The judiciary having interpreted the legislation as intended by Mr. Banks, the failure to include recapitalizations within Section 112(b)(10) has, for the purposes of basis, been largely mitigated. Whereas Section 112(b)(10) provides its own definition of reorganization, a recapitalization, except for the limited purposes of Section 113(b)(4), is governed by the form required under Section 112(g)(1)(d) as qualified by Sections 112(b)(2) and 112(b)(3).

22 140 F. (2d) 382 (1st Cir. 1944), aff'dg 47 B.T.A. 691 (1942).
23 1 T.C. 872 (1943).
24 4 T.C. 931 (1945), aff'd 156 F. (2d) 122 (1st Cir. 1946).
While the statute does not specifically define the term, a recapitalization can generally be categorized as encompassing those reorganizations wherein the corporation readjusts its capital structure within the existing corporate identity. This does not preclude amending the corporate charter. Section 112(b)(2) limits the exchange within the corporation to like stock for stock, common for common and preferred for preferred. Section 112(b)(3), specifying the exchange of stock and securities for stock and securities, enables greater flexibility and is most often found applicable. As shall be noted subsequently, the most serious limitation faced by a Chapter X recapitalization arises from the restricted definition that has been given the term "security."

The continuity of interest issue is present in both Chapter X recapitalizations and reorganizations and should be mentioned, though briefly. It was decided that creditors took "full priority" in the assets of a corporation during either bankruptcy or equity receiverships in *Northern Pacific R.R. Co. v. Boyd.* The Supreme Court, faced with a continuity of interest problem in *Helvering v. Alabama Asphaltic Limestone Co.,* the question arising as to how a proprietary interest could continue through an insolvency reorganization, concluded that both the secured and unsecured creditors could take over the equity interests of the insolvent corporation. That is, upon an insolvency reorganization, the bondholders and other creditors of the insolvent corporation could be given stock of the new corporation, the old equity interests having been eliminated; and viewing the creditors as the beneficial owners of the equity in the insolvent corporation, the subsequent transfer to these creditors maintained the required continuity of interest. Similarly, an exchange of stock of the recapitalized corporation for outstanding bonds and creditors claims should satisfy the continuity of interest requirement. Under the above doctrine, the creditors have assumed the equity interest at some moment before the actual transfer. Thus the transfer simply continues the interest. There is no reason to doubt that the proposition outlined in *Asphaltic* applies equally to all insolvency reorganizations. As pointed out by Dean Griswold, the continuity of interest requirement originated in a construction of the words "consolidation and merger," so that there originally was little

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26 For a discussion of possibilities in recapitalizations, see William A. McSwain, *Recapitalizations, 27 Taxes* 1065 (1949).
27 For pertinent comment see, *Notes* (1947) 56 Yale L. J. 891.
28 228 U.S. 482 (1912).
29 315 U.S. 179 (1942).
if any applicability to a recapitalization. But it would seem that a multitude of courts have failed to see this valid distinction and continue to apply the test to all tax-free reorganizations.

Because the term securities is not defined in the Internal Revenue Code, it is necessary to look to the courts for a working definition. Unfortunately for the party hoping to go through an insolvency recapitalization, the term has been given a narrow construction. Pinellas Ice and Cold Storage Co. v. Commissioner\(^3\) and Cortland Specialty Co. v. Commissioner,\(^3\) while not defining securities, said that a short term note did not come within the applicable meaning, but was the equivalent of cash. Obviously this construction limits the availability of recapitalization as a practical means of insolvency reorganization. As Dean Griswold noted:\(^24\)

"As long as current doctrine that notes are not securities prevails, it would seem to be impossible to have a tax free recapitalization of any corporation no matter how much such a recapitalization may be needed as a matter of business procedure and convenience, where a part of the claims against the corporation is represented by notes or open accounts, as distinguished from stocks and bonds."

Re-examining the limitations imposed upon the term securities, would it not be plausible to contend that because of the application of the "full priority" doctrine to creditors' claims in an insolvency reorganization, the court should look at the "substituted interest" as a security, satisfactory for the purpose of fulfilling the statutory requirement of an exchange solely for stock and securities? The creditors are now the beneficial equity owners of the corporation; they have this "substituted interest" whether the former security interest was secured or unsecured. Relying upon the validity of the Aspaltic doctrine, a court could reasonably recognize that, in fact, these former creditors are holders of securities, that is, the original interest has been replaced by a "substituted interest" which is the equivalent of securities for the purposes of Section 112(b)(3).

Though the courts have not as yet accepted "substituted interests" as the equivalent of securities, the concept of securities is being broadened. In Hoagland Co.,\(^35\) the Tax Court concluded that the exchange of capital stock for the cancellation of a note came within the provisions of Section 112(b)(3). Whether the promissory note was considered a security was not placed in issue by the petitioner. Al-

\(^{31}\) For a discussion of the background and development of the "Continuity of Interest" concept, see, Valentine Brookes, *The Continuity of Interest Test in Reorganizations—a Blessing or a Curse*, 34 Cal. L. Rev. 1 (1946).

\(^{32}\) 287 U.S. 462 (1933).

\(^{33}\) 60 F. (2d) 937 (2d Cir. 1932), cert. denied, 288 U.S. 599 (1933).

\(^{24}\) Griswold, *supra* note 30, at 718.

\(^{35}\) Hoagland Co. 42 B.T.A. 13 (1940), aff'd 121 F. (2d) 962 (2d Cir. 1941).
though the second circuit affirmed the decision, Judge Learned Hand's opinion proceeds on alternative grounds so that the decision can in no way be cited as firm authority for the proposition that a promissory note now qualifies as a security. It appears that, while tempting to give the term more flexibility, the courts refuse to refute the basic limitations imposed in Pinellas.

If the party receiving the stock or security has any stock or security to give in return, regardless of its present value or lack of same, the door is apparently open to all additional claims along with the exchange of the stock or securities.36

There are several avenues of possible relief short of legislative redetermination of the meaning of securities. The Court can reexamine Pinellas and, short of repudiating it, can narrowly limit the case. But if the past is any indication of the future there is small chance of this. A judicial recognition of "substituted interests" as securities in insolvency reorganizations should be possible within the ambit of Pinellas. Until one of the above possibilities is realized, recapitalization, under a Chapter X plan, excepting for particularly favorable circumstances such as found in the Robert Dollar Co. case,37 is unavailable to the majority of insolvent corporations.38

36 United Gas Improvement Co. v. Comm'r., 142 F. (2d) 216 aff'g 47 B.T.A. 715. The parent Co. cancelled all of its stock, held to be an exchange. Estelle Pardee Erdman, PH 1946 T. C. Mem. Dec. 72. The petitioner, in exchange for an open account and notes, received notes maturing in 20 years and new stock. The maturity dates of the old notes were not shown, but the failure of proof on the part of the respondent may not be used to base a holding that the obligations were short term notes and, therefore, not securities within the statute. The notes and stock received in the exchange are clearly securities under the statute. The fact that an ordinary debt due from the reorganized corporation formed part of the consideration for the exchange does not take the exchange out of Section 112(b) (3); Comm'r. v. Bachrach, 182 F. (2d) 261 (7th Cir. 1950). Exchange by corporation of certificates of indebtedness for second mortgage bonds according to a 77B plan of reorganization qualifies under Section 112(b) (3); Comm'r. v. Carman, 189 F. (2d) 363 (2d Cir. 1951). Old bonds and past due interest held to constitute single claim and exchange for new bonds and stock including stock allocated to this accumulated and unpaid interest will qualify under Section 112(b) (3); Robert Dollar Co. 18 T.C. 444 (1952). Stock declared valueless and cancelled by the court handling the 77B reorganization. Old stock holder also creditor and received new stock based upon the value of its creditors claims. Court refuses to accept the bankruptcy court's valuation and discovers that the stock (original) still has some value and says that this stock as well as the creditors' claims are exchanged for the new stock and the reorganization therefore qualifies under X Section 112(b) (3). This is stretching form to extremes.

37 Robert Dollar Co., supra note 36.

38 Another possible obstacle to be faced in an insolvency recapitalization is state regulation, Sen. Rep. No. 627, 78th Cong., 1st Sess. 51 (1943), "Where the corporation is insolvent, this type of adjustment is generally not possible for the reason that under the absolute priority rule stockholders may no longer have an interest in the corporation and, therefore, may not participate in the corporation as reorganized. In order to use the old corporate structure to effect the reorganization, it is usually necessary that amendments to the Articles of Incorporation be made. Where the stockholders do not participate in the corporation as reorganized, it is more often than not impossible to
corporation will ordinarily require that a substantial amount of creditors' claims be settled during the reorganization, and, as previously noted, stock and securities of the recapitalized corporation are not available for the satisfaction of general creditors.

While the phrase "solely for stock and securities" is also found in Section 112(b)(10), the restrictive effect is alleviated by reference to Section 112(k). This section provides for the assumption of the insolvent corporation's liabilities by the transferee corporation, made use of in the Chapter X plan. Thereafter the new corporation's manner of handling the assumed liabilities will have no effect upon the original qualification within Section 112(b)(10).

**Possibility of Carry-overs**

As noted, the statutory language of Section 112(b)(10) requires a transfer of the insolvent corporation's assets to another corporation. This requirement subjects the newly reorganized corporation to the limitations enunciated in *New Colonial Ice Co. v. Helvering*, where-in the court rejected the contention that a newly reorganized corporation, taking over assets and liabilities of the old corporation and operating the business as if no change had occurred in the corporate structure, was for all practical purposes the same entity as the old corporation and, therefore, the same "taxpayer": it following that the new corporation should be able to take advantage of the old corporation's net operating losses. Rather, the court contended, there is a separate and distinct successor entity created and it is viewed as such by all of the concerned parties. Of course, the distinctness was emphasized in *New Colonial* because, while not transacting business of any kind, the transferor corporation was not liquidated until more than a year after the reorganization. The court was able to point to two individual corporations in existence at the same time to bolster its contention that the transferee was an entirely independent corporation. This has not become a determinative factor and the immediate dissolution of the transferor corporation was not liquidated until more than a year after the reorganization. The court was able to point to two individual corporations in existence at the same time to bolster its contention that the transferee was an entirely independent corporation. This has not become a determinative factor and the immediate dissolution of the transferor corporation has not effected the outcome under *New Colonial, Inc.* Thus qualification under the terms of Section 112(b)(10) eliminates the advantage of those net operating losses that usually are available to the insolvent corporation.

This result is infortuitous in that such a tax advantage would act

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obtain the vote of a sufficient number of shares to amend the Articles. In some few states, however, the state laws provide that the Trustee in bankruptcy or receivership proceedings may vote the shares of the insolvent corporation. In such cases reorganization is easier than to transfer to a new corporation." It would seem that in the light of Chapter X and the general doctrine of Federal Supremacy, the bankruptcy court can order the stock of displaced shareholders to be voted by the Trustee in Bankruptcy, the above observation is unduly pessimistic. See Cramp Down clause 52 Stat. 895 (1938), 11 U.S.C. §616 (1946).

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as a stimulus to insolvent corporations to seek a reorganization rather than liquidation. The largest number of insolvency reorganizations occur during the event of a depression or recession, and it can safely be assumed that the adverse market and general outlook facing the reorganized corporation will be closely parallel to that market faced by its predecessor. The aid gained from the carry-over of the predecessor’s net operating losses could prove a significant factor in the corporation regaining financial solidarity. Chapter X was provided to enable faltering industrials to revive. To revive the allowance of this carry-over would certainly advance that policy.

A possible means to avoid New Colonial Ice may have been presented in Stanton Brewery, Inc. v. Commissioner, wherein the second circuit decided that in a merger of two corporations the surviving corporation could make use of the former and now extinct corporation’s excess profits tax credit. In that instance the operating corporation was merged with the holding company. The Tax Commissioner had refused to allow the resulting organization, which had taken the name of the operating corporation, to carry over the excess profits credits due the former operating corporation. But the court refused to apply New Colonial Ice. Instead the court said,

“We must regard the resulting corporation as the union of component corporations into an all endeavoring whole which absorbs the rights and privileges, as well as the obligations, of its constituents.”

The court placed great stress on the fact that the statute refers to “taxpayers.” It concludes that the corporation, because of the continuity of the business enterprise, the assumption of liabilities and the primary liability for taxes of the old corporation, should be viewed as the same “taxpayer.” Section 112(b)(10) reorganizations can be cast in the form of a merger to take advantage of Stanton.

Whether Stanton could at present be extended to net operating losses seems doubtful in light of the fact that New Colonial Ice remains unimpeached. Still it would follow that if the court’s logic is valid in regards the excess profits tax credits, it should be equally applicable to net operating losses. The expansion of this reasoning to insolvency reorganizations would end the unequal tax treatment that results from differences in form. But for the present, Stanton has been refused extension by the Tax Court. In a very recent case the District Court specifically refused to apply Stanton to the attempted

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41 176 F. (2d) 573 (2d Cir. 1949), rev’g 11 T.C. 310 (1948).
42 176 F. (2d) 573 (2d Cir. 1949).
43 California Casket Co., 19 T.C., No. 7 (1952).
carry-over of net operating losses by a newly reorganized corporation. The corporation, following a Section 77B plan of reorganization, had acquired assets and assumed liabilities of the old company. The tenor of the opinion certainly precludes hope of the extension of the *Stanton* case to cover the above situation. Apparently a change in the statute governing insolvency reorganizations will be required to allow the carry-over of net operating losses. The American Bar Association has recommended an amendment to the Code that would allow the transferee corporation, participating in a tax free reorganization, to take full advantage of net operating losses and unused excess profits credit carry-overs. In order that this same problem, that is, the inequality of treatment as between recapitalizations and reorganizations, might be eliminated in railroad reorganizations, a statute was passed allowing the carry-over of these items regardless of the form of the reorganization chosen. This motivation is an equally valid one when applied to industrial and other insolvency reorganizations.

Ordinarily the newly reorganized corporation cannot take advantage of any deficit in earnings and profits suffered by the predecessor insolvent corporation. The customary form of a Section 112(b)(10) reorganization places the insolvent corporation in the position of the corporation that is to be eliminated, while the transferee is viewed as the surviving corporation. In light of the doctrine enunciated in *Commissioner v. Phipps*, there can be no carry-over of the earnings deficit to the transferee corporation so as to begin the earnings history of the surviving corporation with this beneficial deficit. The language of the statute is explicit and definitely fixes the form of the transfer, "a transfer to a corporation organized or made use of." It must be concluded that the present wording and interpretation of Section 112 (b)(10) affords no opportunity for the transferee corporation's beneficial use of the transferor's net operating losses or earnings deficits.

The possibility of arranging a Chapter X reorganization so as to take advantage of the deficit in earnings of the insolvent corporation is undoubtedly present. The Court's interpretation of *Harter v. Helvering* would seem to encourage such a juggling of the reorganization plan. That is, instead of having a new corporation take over the assets of the insolvent corporation, make use of an existing corp-

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45 *Hearings before Committee on Ways and Means on H.R. 80th Cong., 1st Sess. 983* (1947). This recommendation did not specifically refer to insolvency reorganizations but recommended amendments to Sections 122(b) and 710(c)(3).


47 336 U.S. 410 (1949).


49 79 F. (2d) 12 (2d Cir. 1935).
oration by merging it into the insolvent corporation, making the insolvent corporation the surviving corporation. But the practicality of this procedure must be measured in the light of the complications that are sure to arise.

Following this tangent, the reorganization would immediately lose the benefits of Section 112(b)(10) specifically, exemption from Section 270 of the Bankruptcy Act and also the benefit of the definition of reorganization in Section 112(b)(10). Sections 112(c), (d) and (k) would still apply, assuming the reorganization qualified under Sections 12(b)(4) or (5). It is extremely questionable, of course, whether this roundabout means of reorganization, obviously chosen because of the tax advantage, would meet with the Bankruptcy Court's approval. The Commissioner of Internal Revenue has a valid right to challenge the reorganization plan in the bankruptcy Court, invoking Section 269,50 and though in practice this is seldom done, in the aforementioned variation of Chapter X Plan it must be considered as a definite possibility. Section 129 would also provide an obstacle to this kind of plan, except for the case of insolvency in the subsidiary of a solvent corporation. Weighing these impediments against the possible advantage to be gained by the carry-over of the assumed earnings deficit,51 it becomes clear that an unusual factual situation is required to justify the risk of a taxable transfer that is inherent in the deviation from a Section 112(b)(10) plan of reorganization.

Where the same corporate entity is maintained through the insolvency reorganization, that is, a recapitalization, the doctrine of New Colonial Ice is inapplicable. Full advantage can be taken of net operating losses and excess profit tax credits because, for tax purposes as well as in fact, the same corporate entity is continued although the personality of the equity interests may be completely changed. As recognized earlier, the reorganizational possibilities are limited under Section 112(g)(1)(d) or a greater number of insolvent corporations would take advantage of these benefits. Obviously the temptation is always present, but the statutory framework remains inflexible. Even though this statutory hurdle is passed, the recapitalization falls outside of the beneficial basis provisions, but is no longer a consideration of overwhelming proportions.

50 52 STAT. 904 (1938), 11 U.S.C. §669 (1946). "Where it appears that a plan has for one of its principal purposes the avoidance of taxes, objection to its confirmation may be made on that ground by the Secretary of the Treasury, or in the case of a State, by the corresponding official or other person so authorized. Such objections shall be heard and determined by the judge, independently of other objections which may be made to the confirmation of the plan, and, if the judge shall be satisfied that such purpose exists, he shall refuse to confirm the plan."

51 It is assumed in the discussion that the insolvent corporation has a substantial earnings deficit.
Congress was cognizant of this inconsistent treatment. The Senate attempted to rectify the situation insofar as excess profits credits were concerned, but because of House opposition the attempt proved abortive.

The taxpayer, about to undertake an insolvency reorganization, has at least three possible choices under a Chapter X plan: a Section 112(b)(10) reorganization, a Chapter X plan not qualifying under Section 112(b)(10) because of its attempt to take advantage of Harter, that is, take advantage of deficit earnings, and a chapter X recapitalization. The tax consequences of each differ to such an extent that the primary purpose of a Chapter X plan, the strongest possible capital structure for the reorganized corporation, must compete with the taxpayer's desire to obtain the most favorable tax treatment. This result is not consistent with the overall policy of the Bankruptcy Act.

Humpage Case—Earnings and Profits

Finally, we look to the possibility of the application of the doctrine originating in Commissioner v. Sansome to a Chapter X reorganization. Upon observation, it is noted that in the great majority of instances the insolvent corporation will be without earnings and profits, for seven these earnings totally diminished by the operating losses that eventually result in insolvency. But as exemplified by Humpage v. Commissioner, an insolvent corporation possessing earnings and profits at the time of its reorganization is possible. Disregarding for the moment whether earnings and profits should be carried forward if present in the insolvent corporation, the immediate issue is, have such earnings and profits been subject to the Sansome reasoning? The Humpage case is the first to decide this question. The Tax Court concludes that the "Sansome Rule" is not applicable to a Section 77B reorganization.

In the Humpage case, the Commissioner attempted to assess an additional tax upon two shareholders of the Fisher Corporation, on the determination that the dividend received by each from the Fisher Corporation was taxable as ordinary income, because the Fisher Corporation had accumulated earnings and profits sufficient to cover the entire dividend. Fisher Corporation, the successor of Fisher Company, was organized under a Section 77B plan of reorganization in

52 See note 20 supra.
53 60 F. (2d) 931 (2d Cir. 1932).
54 17 T.C. 1625 (1952).
55 The court refers to the application of the Sansome case as the "Sansome Rule." That is, all earnings and profits are continued in a tax free reorganization where the assets of one corporation are transferred to a successor corporation. The term will be used in this article only as it was applied by the Tax Court in the Humpage Case.
56 The insolvent corporation shall be referred to as the Fisher Company and the successor corporation shall be referred to as the Fisher Corporation.
1935. Its predecessor was the guarantor of the payment of principal and interest on an outstanding issue of mortgage and gold bonds valued at $3,000,000, issued by the Montauck Corporation and defaulted by same in 1932. Fisher Company underwent a voluntary reorganization under Section 77B because of its inability to meet this guarantee. Because it kept its accounts on a cash basis, Fisher Company was unable to credit this fixed liability against its surplus or realize an operating loss that would have totally extinguished the earnings and profits. This resulted in the anomalous situation of Fisher Company having a fixed liability of over $3,000,000 on its guarantee and earnings and profits of approximately $2,500,000 when it underwent its insolvency reorganization.

After determining that the plan of reorganization qualified as tax free, the Commissioner applied the "Sansome Rule" and held that the Fisher Corporation had acquired the $2,500,000 in earnings and profits from the insolvent Fisher Company. The reorganization wiped out the entire equity interests of the former shareholders, the liability on the guarantee being satisfied by a distribution of stock of the Fisher Corporation to the former Bond holders.

The Tax Court reversed the Commissioner, deciding that the earnings of Fisher Company did not pass to the Fisher Corporation and hence were not a part of Fisher Corporation's earnings and profits. Thus so much of the dividend as exceeded the corporation's earnings and profits, accrued in the year of the dividend and accumulated since the reorganization, was a return of capital and not taxable as ordinary income. The court's rationalization follows.

Under the doctrine proclaimed in Asphaltic, the creditors took "full priority" in the assets of the insolvent corporation and became the beneficial equity owners of the corporation before the formal reorganization. Such a change in interest took place at the time when the creditors invoked their legal rights, in this case represented by the petition under 77B, although the court does not state definitely when the change took place. Then turning to McClintic Estate v. Commissioner, for the proposition that the acquisition of the ownership of the assets of a corporation carries with it ownership of the surplus, the court concluded that the surplus, including the earnings and profits, passed to the former creditors of Fisher Company along with that company's assets when the creditors took their equitable interest under the "full priority" doctrine. The Court said:

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57 The bond liability including interest was $3,213,240.
58 The earnings and profits at the time of the 77B reorganization totaled not less than $2,188,183.27 or more than $2,395,093.93.
59 47 B.T.A. 188 (1942).
60 Humphage v. Commissioner, 17 T.C. 1625, 1633 (1952).
"Whether or not the claim of the Montauk bondholders under the guarantee served to reduce Fisher Company's accumulated earnings such earnings were distributed to the creditors when they acquired beneficial ownership of the assets and they were no longer earnings in the hands of Fisher Company."

The court calls the subsequent transfer of the assets from Fisher Company to its successor in effect a purchase of the shares of the successor.

In order to support its position the Tax Court has made an attenuated interpretation of the Asphaltic case and the "full priority" doctrine. In effect, it is proposing that when the creditors take over the position of the former equity owners, they have purchased the so-called surplus along with the corporate assets. The court doesn't decide whether or not this is a taxable transaction, but infers that if any loss or gain results it should be recognized at this time. It has looked at this change in interest as a pseudo purchase of the corporation's assets with the accompanying devolution of earnings and profits. The invalidity of this approach is obvious.

When the creditors gain their substituted interest, they have obtained the interest of the former shareholders. A transaction much more analogous to the situation involved above would be illustrated by a sale by each of the shareholders of his equity interest, as represented by his own particular shares, to the creditors. It is nowhere contended that the sale of the individual shares is a sale also of the assets and surplus of a corporation that will be reflected in corporate accounts, although the share does represent an aliquot interest in the capital. The corporate entity is unaffected by these transfers among the shareholders; the surplus and earnings continue unchanged as part of the whole. The Tax Court's reference to the McClintic case does not sustain its contention. The situation was not at all comparable to the Humpage case. As pointed out in McClintic, when a corporation, by means of a split-off or spin-off, transfers property to another corporation, it follows that a proportional part of the original corporation's surplus and earnings also pass to the acquiring corporation. The above situation is not comparable to a sale by X of his stock to Y, or the substitution of Y as owner of the corporation's stock for X. Neither of these transactions produces any effect on the corporate surplus.

The doctrine of "full priority" does not turn on the basis of a purchase of the assets of the insolvent corporation and in turn a portion of the surplus, but rather, as was emphasized in Asphaltic, a substitution of the creditors in the place of the shareholders. But the

61 For those items and transactions that have an effect on earnings and profits see W. Austin, Corporate Earnings and Profits Under the Internal Revenue Code, 4 Baylor L. Rev. 129 (1952); Arthur R. Albrecht, "Dividends" and Earnings or Profits, 7 Tax L. Rev. 157 (1952).
Tax Court viewed this substitution of interest as a separate and independent transaction. Adherence to the principle of the "full priority" doctrine does not of itself lead to the possibility of a taxable transaction. If a liquidation should result from the insolvency proceedings instead of the reorganization, the "full priority" doctrine would have effect, but only so far as it established preferences in the distribution of assets to the creditors.

It is a case of the Tax Court viewing this substitution of interests as a completed transaction, for tax purposes, between the creditor and the corporation rather than as between creditor and shareholder. It does not follow that the earnings along with surplus of Fisher Company were distributed to the creditors, when they acquired the beneficial ownership of the equity interest, any more than it would follow that earnings and surplus are distributed to new shareholders when they acquire a proprietary interest upon a purchase of outstanding shares of a corporation. The creditors, whose interests are substituted, are the equivalent of shareholders during the reorganization when they receive their interest; rather than being capital in their hands, it represents a claim to capital.62

The Tax Court extends the reasoning of the U.S. v. Cement Investors, Inc.63 decision beyond its cognizable limits. The court in that case refused to decide the issue as to whether the substitution of interests of the creditors for the equity holder’s interest was a separate transaction subject to Section 112(a). It is more feasible to consider the shifting of the equitable interests in question as part of a contemplated tax free plan of reorganization. The opposite conclusion would be a contradiction of the policy of both the Bankruptcy Act and Internal Revenue Code.

Acceptance of the Tax Court’s view would require a definite determination as to precisely when the substitution takes place, so as to allow the so-called realization of gain or loss to the creditor. Assuming that such a transfer takes place at the time of the petition in bankruptcy, it would appear that the creditor would never realize a gain. Such creditor would be receiving a pro rata share of the equity based upon the amount of credit extended and the priority of same.64 That amount would never, at the time of the substitution, exceed the basis

62 Humpage v. Commissioner, 17 T.C. 1625, 1634 (1952), "Whether or not the extinguishment of the claims of the creditors resulted in gain or loss to them, the assets that they received constituted capital in their hands."
63 316 U.S. 527, 535 (1942). “Thus the contention seems to be that, since a gain arose from a transaction which was separate and distinct from and anterior to the exchange of property for the new securities, it must be recognized under the general rule of Section 112(a). We express no view on that contention.”
64 This discussion encompasses only those parties having acquired an equity interest prior to the economic failures responsible for loss in value of such equity interest. The speculative aspect of the problem is not considered herein.
of the original credit extended. This leads, then, to the problem of evaluation and recognition of losses. The creditor would begin with the basis of his bonds or other claims. In order to estimate loss it would be necessary to evaluate the equity interests received in satisfaction of claims at the time of the substitution. At the time of the transaction, especially in the case of a reorganization, the valuation problem would be difficult if not impossible. It seems much more reasonable that these difficulties were meant to be avoided by viewing the substitution as part of the whole plan and relying upon Sections 113(a)(6) and (a)(22) to settle the collateral basis problems.

*Cement Investors and Asphaltic* can best be interpreted in conjunction with *Northern Pacific R.R. v. Boyd* and *Case v. Los Angeles Lumber Co.* The concept of the bondholders and creditors simply taking over the equity interest of the shareholders in part or completely, obviously used in *Asphaltic* as a means of maintaining the required continuity of interest, also presents a valid explanation of what, in fact, occurs. The equity interest is totally submerged by that of the creditors. It can be maintained by the shareholders, but only by additional contributions of capital. In the *Boyd* case the shareholders' equity, i.e., capital, was viewed as a trust fund subject to the payment of all corporate debts, the shareholders' interests remaining unrecognized until final satisfaction of all these claims.

It is necessary to draw the distinction between "full priority" of creditors in a liquidation, and the same priority in a plan of reorganization. In the former, the creditors have an absolute preference to realize upon the assets of the corporation that cannot be denied. But this in itself does not make the creditors equity holders of the corporation. When the creditors decide not to force a liquidation, but rather to participate in a plan of reorganization, they then assume a substituted interest, and can then be called holders of an equity interest. The equity interest received is substituted for their original claim and its immediate enforcement. In this latter case, the transition from creditors to equitable owners is part of the contemplated plan of reorganization. The court has not looked to each particular facet of a reorganization as a separate transaction. The court said in *Asphaltic*,

"Yet, the separate steps were integrated parts of a single scheme. Transitory phases of an arrangement frequently are disregarded under these sections of the revenue acts where they add nothing of substance to the completed affair."

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65 308 U.S. 106 (1939). "It is a fixed principle, governing under 77B of the Bankruptcy Act as well as in equity reorganizations, that, to the extent of their debts, creditors are entitled to absolute priority over stockholders against all the property of an insolvent corporation, relative priority not being enough."

66 315 U.S. 179, 184 (1942).
As illustrative of Congressional thought on the subject of collateral transactions to a reorganization, Congress said just after the passage of Section 112(b)(10): 67

"No antecedent or component transaction in connection with such relinquishment or extinguishment and subsequent acquisition is recognized as a taxable event under this amendment."

The Tax Court's assumption that a separate transaction of substance took place in the Humpage case is falacious. It is necessary to conclude, in contradiction to the Tax Court, that the earnings and profits of Fisher Company did not pass to the creditors at the time of the insolvency reorganization.

But the issue of whether these earnings and profits should be carried forward in this instance is not concluded. According to the policy adhered to in Slover v. Commissioner 68 and reaffirmed in Munter v. U.S., 69 the purpose of carrying forward earnings and profits is to avoid a tax free distribution of accumulated earnings. Is this a possibility in a bona fide insolvency proceeding? It is perhaps redundant to say that, ordinary, accumulated income and earnings is the antithesis of corporate insolvency. The earnings and profits remain in Fisher Company because of an inadequacy of accounting methods. In fact, the liability of $3,000,000 was recognized and satisfied during the reorganization though the earnings and profits could not be corresponding reduced. With the possibility of a tax free distribution removed, it would follow from Munter that these fictitious earnings and profits should not be carried forward. The Humpage court also distinguished this reorganization from the ordinary tax free reorganization because of the corporation's insolvency, stressing the fact that none of the litigated cases involving the "Sansome Rule" or doctrine were insolvency reorganizations. The merit of this distinction is questionable except to emphasize the uniqueness of this situation. Although it has been said that Sansome 70 applies to all tax free reorganizations wherein the transferor corporation has earnings and profits, this case should prove the exception to the rule, since here the very purpose for its application no longer exist.

**CONCLUSION**

Upon retrospection, it should be obvious that the differences noted in the tax treatment of reorganizations and recapitalizations points up

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68 6 T.C. 884, 886 (1946), "The origin and purpose of the "Sansome Rule" has repeatedly been described as based upon the danger that otherwise distribution of accumulated earnings to stockholders would escape tax."
70 Ralph S. Rice, Transfers of Earnings and Deficits in Tax-Free Reorganizations; the Sansome-Phipps Rule, 5 Tax L. Rev. 523, 528 (1950).
a serious need for corrective legislation. A Section 112(b)(10) reorganization has the benefit of Section 268 of the Bankruptcy Act in conjunction with its basis provision, Section 113(a)(22), a more flexible definition of reorganization, and the possibility of the carry-over of any unused excess profits credits from its transferor corporation. Recapitalization, while limited by the scope of a Section 112(g) definition of reorganization, the judicial qualifications of the term "securities" and denied the benefit of Section 268 by the application of Section 270, has the advantage of net operating loss carry-over, excess profits credit carry-over, and the earnings deficit carry-over. The allowance of these carry-over benefits often makes a recapitalization extremely desirable, while the corresponding inflexibility of the term "securities" usually makes its application unlikely.

Again looking to the primary motivation of Congress for the passage of Chapter X, the desire to maintain a stable, flexible and healthy national economy, it is suggested that an amendment to the Internal Revenue Code is requisite to more successfully achieve this goal. The composite tax advantages mentioned above should be allowed to all insolvency reorganizations regardless of form. This can be accomplished by a provision amending Section 112(b)(10) to include recapitalizations and to specifically provide for the carry-over of net operating losses, excess profits credits and deficit earnings in all insolvency reorganizations. In addition, the term "securities" should be given a fresh determination, as regards insolvency reorganizations.

Opposition to the above amendment would in all probability be vigorous. As an alternative measure, it is recommended that Section 112(b)(10) be amended to include recapitalizations with the more flexible definition of "securities." It should provide that for purposes of any insolvency reorganization under Chapter X, regardless of form, it will be considered to be a reorganization for tax purposes.

The end result under both of the the suggested amendments is equality of tax treatment. The form of the reorganization could then be chosen without undo consideration for tax consequences.

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\(^{11}\) As indicative of this opposition see the President’s criticism of the Reorganization provisions in the Revenue Act of 1943, 90th Cong. Rec., Feb. 23, 1944 at 1973 (1944).