Louisiana Law Review

Volume 21 | Number 4
June 1961

Income Tax - Gain From a Stock For Stock Plus Boot Transaction

Martin Smith Jr.

of the correctness of the holding in the instant case, the use of the device approved by the court appears to offer a wide avenue for avoiding estate taxes.

Merwin M. Brandon, Jr.

INCOME TAX — GAIN FROM A STOCK FOR STOCK PLUS BOOT TRANSACTION

Taxpayer, sole stockholder of International Dairy Supply Company, transferred his stock in that company to Foremost Dairies, Inc., for 82,375 shares of the common stock of Foremost and $3,000,000.00 cash. He reported a capital gain on the transaction limited to the cash less certain expenses. The Commissioner determined that the entire gain, $4,163,691.94, was recognizable at the time of the transaction and assessed taxpayer for the deficiency. The Tax Court held that the recognizable gain on the transaction was to be limited to the cash received.[1] On appeal to the United States Court of Appeals, Ninth Circuit, *held*, reversed. An exchange in which cash plus voting stock is received is not a reorganization.[2] The entire amount of the gain is recognizable at the time of the transaction. *Commissioner v. Turnbow*, 286 F.2d 669 (9th Cir. 1960).

Generally, gains on sales or exchanges are recognizable to the full amount of the gain at the time of the transaction.[3] However, it was early recognized that it would be desirable to delay recognition of gain so that business readjustments could be made without tax consequences in cases where the stockholders in the enterprise are retaining their interests without the receipt of cash and the essential continuity of business is being preserved.[4]

---

contemplation of death. While the court did not accede to this point, it should be noted that the agreement involved in the *Gore* case provided for the estate to receive the same amount which the decedent would have received had he sold out during his lifetime. That fact might well make the reasoning of the *Gore* case inapplicable in situations similar to the *Land* case, where the agreement provides for a change in the value of the business interest when the partner's estate, rather than the partner, is the vendor.

1. Grover D. Turnbow, 32 T.C. 646 (1959).

2. The only reorganization definition that could be applicable would be Int. Rev. Code of 1939, § 112(g) (1)(B), now INT. REV. CODE OF 1954, § 368(a)(1)(B). See note 11 *infra*.

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

4. Letter from Secretary of Treasury, 78 Cong. Rec. 2512 (1934). See, generally, SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (1938).

To implement this policy, Congress has continually provided for non-recognition of gain resulting from corporate reorganizations.[5] No gain or loss is recognized by parties to a reorganization if stock or securities in a corporation a party to the reorganization are, in pursuance of the plan of reorganization, exchanged *solely* for stock or securities of another corporate party to the reorganization.[6] If there were no further qualification of this rule, the receipt of consideration other than stock or securities would result in recognition of the entire gain on the reorganization at the time of the transaction.[7] However, this provision has been specifically modified to provide that where there would have been a non-recognizable gain except for consideration received other than stock or securities of a corporate party to the reorganization, gain will be recognized but will be limited to the amount of "other consideration" or "boot" received.[8] Thus, through the "boot" provision, the taxpayer is permitted to defer recognition of gain on a reorganization to the extent that he receives stock and securities of a corporation a party to the reorganization.[9]

The structure of the reorganization provisions of the Internal Revenue Codes of 1939 and 1954 indicate that a prerequisite to the applicability of any of the provisions limiting recognition of gain is that the transaction under consideration meet the statutory definition of a *reorganization.*[10] Six statutory definitions of the term reorganization are supplied by the Internal Revenue Codes, including the two which are pertinent here.[11] The In-

5. Revenue Act of 1921, ch. 136, § 202(c).

6. Int. Rev. Code of 1939, ch. 1, § 112(g), 53 Stat. 40, as amended ch. 247, 53 Stat. 870 (1939), now INT. REV. CODE OF 1954, § 368.

7. The transaction would not then be for *solely* stock or securities of a corporate party to the reorganization.

8. Int. Rev. Code of 1939, ch. 1, § 112(c), 53 Stat. 39, now INT. REV. CODE OF 1954, § 356. The provision enumerates the sections it modifies; hence it could be assumed that the enumeration is intended to be exclusive.

9. The purpose of this entire section of the Internal Revenue Code is to defer payment of tax on a transaction until a future date, with a view to allowing the "specified" types of reorganizations to be accomplished without the necessity of payment of tax on "unrealized paper profits." See note 2 *supra.*

10. Int. Rev. Code of 1939, § 112(g)(1)(B), now INT. REV. CODE OF 1954, § 368(a)(1)(B), defines reorganizations. Section 112(b)(3) of the 1939 Code (now Section 354(a)(1) of the 1954 Code) provides that where solely stock or securities are exchanged where there is *a reorganization* no gain or loss is to be recognized. Section 112(c) of the 1939 Code (now Section 356(a) of the 1954 Code) provides that where a gain on a transaction would be tax free but for the *solely* provision of Section 112(b)(3) of the 1939 Code (now Section 354(a)(1) of the 1954 Code), gain will be recognized but limited to the amount of "boot" received.

11. These definitions include (a) a statutory merger or consolidation; (b) the acquisition by one corporation, in exchange solely for all or a part of its voting

ternal Revenue Code of 1939 requires that in order to qualify the acquiring corporation give *solely voting stock* as consideration either for 80% of all classes of stock of another corporation[12] or for substantially all the properties of another corporation.[13] Since both definitions require the acquiring corporation to give *solely voting stock*, it would appear that the transaction would not be a "reorganization" by statutory definition if some consideration other than voting stock were given. If there were a statutory provision to allow the exchange of stock to be considered as a transaction apart from the "boot" received, the transaction could meet the statutory definition of reorganization. However, the only provision which might be applicable, the "boot" provision,[14] is limited to certain sections of the Code, not including the reorganization definitions.[15] Since the "boot" provision does not modify the reorganization definitions, a stock for stock transaction which includes "boot" would seem to come under the general rule[16] making both gains and losses fully recognizable at the time of the transactions.[17]

The "solely for voting stock" requirement of the reorganization definitions under consideration was added to the law in 1934 because of concern over the use of these definitions to cast transactions which were in substance taxable sales in the technical form of reorganizations.[18] In interpreting this requirement

---

stock, of at least 80 per cent of the voting stock and at least 80 per cent of the total number of shares of all other classes of stock of another corporation; (c) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting 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; (d) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred; (e) a recapitalization; (f) a mere change in identity, form, or place of organization, however effected. Int. Rev. Code of 1939, ch. 1, § 112(g)(1), 53 Stat. 40, as amended, ch. 247, 53 Stat. 870 (1939), now INT. REV. CODE OF 1954, § 368.

12. Section 112(g)(1)(B). See note 11 *supra*.

13. Section 112(g)(1)(C). See note 11 *supra*.

14. Int. Rev. Code of 1939, § 112(c), 53 Stat. 39, now INT. REV. CODE OF 1954, § 356(a).

15. See notes 8 and 10 *supra*.

16. See note 3 *supra*.

17. Commissioner v. Turnbow, 286 F.2d 669 (9th Cir. 1960). See Helvering v. Southwest Consolidated Corp., 315 U.S. 194 (1942); *contra*, Howard v. Commissioner, 238 F.2d 943 (7th Cir. 1956).

18. See note 8 *supra*. The "solely for voting stock" requirement was added to correct abuses of the existing law. The House Ways and Means Subcommittee thought the abuses so flagrant that they proposed that the reorganization provisions in Section 112 be abolished. H.R. Rep., 73d Cong., 2d Sess. (Dec. 4, 1933). However, the committee decided that the wiser course would be to amend drastic-

the Supreme Court in *Helvering v. Southwest Consolidated Corporation*[19] said: "Congress has provided that the . . . [exchange] must be 'solely' for 'voting stock' of the transferee. 'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory requirement."[20] It must be noted, however, that in the *Southwest Consolidated* case the issue involved did not bring the "boot" provision before the consideration of the Court.[21]

The problem of the applicability of the "boot" provision in connection with the "solely for voting stock" requirement was presented to the Seventh Circuit in *Howard v. Commissioner*.[22] Petitioners had exchanged 80.19% of the total number of shares of stock for "solely for voting stock" of the acquiring corporation whereas other stockholders exchanged the remaining shares for cash. In holding that the petitioners had no recognizable gain at the time of the transaction, the court said "*but for* the cash received in exchange for the 19.81% of the . . . stock . . . , the transaction would have met the 'solely' requirement of . . . [the reorganization definition]."[23] Thus, in effect, the Seventh Circuit determined that whether a transaction meets the reorganization *definition* is to be determined by considering the transaction separate and apart from the boot received.[24]

Another possible construction of the statutory definition of reorganization was rejected by the Court in *Howard v. Commissioner*. It was argued there that the definition could be construed to mean that an exchange where at least 80% of the stock of a corporate party to a reorganization was acquired "solely for voting stock" of another corporate party would be a reorganiza-

ally the provisions so as to stop the known cases of tax avoidance, rather than to eliminate the sections completely. H.R. No. 704, 73d Cong., 2d Sess. (1933).

19. 315 U.S. 194 (1942).

20. *Id.* at 198.

21. The carry-over basis of Int. Rev. Code of 1939, § 113(a)(7) was at issue. *Id.* at 196.

22. 238 F.2d 943 (7th Cir. 1956).

23. *Id.* at 948.

24. It is difficult to determine how the applicable sections could be construed to permit the "boot" provision to modify the definition of a reorganization. The "boot" provision, Int. Rev. Code of 1939, § 112(c), provides that where the exchange would be within the provisions of Section 112(b)(3), but for "boot" received, gain will be recognized but limited to the amount of the boot. Section 112(b)(3) provides no gain or loss is to be recognized where solely stock is exchanged for stock in pursuance of a plan of reorganization. Section 112(b)(3) provides no definition of the term reorganization. The definition is provided in Section 112(g)(1)(B) of which Section 112(c) makes no mention. It would appear that Section 112(c) should not modify the definition of reorganization. See notes 8 and 10 *supra*.

tion even though other stockholders were given cash or other consideration for the remaining stock.[25] The court, however, found that the construction of the "solely for voting stock" in the *Southwest Consolidated* case was decisive of this point in that all the consideration received by all parties must be "solely voting stock."[26]

In the instant case the Ninth Circuit Court of Appeals, rejecting the *Howard* rationale, held that the transaction did not qualify as a reorganization due to the "solely for voting stock" requirement which precluded the receipt of "boot." Since the instant transaction was not a reorganization, the "boot" provision could not operate to limit the recognizable gain.

One factor considered in both the *Howard* and the instant cases was the potential effect of the decisions on the possibility of recognition of losses from exchanges not solely in kind.[27] The provision for limiting the recognition of losses from exchanges not solely in kind, a companion provision of the limitation of gain provision, states that, where there would have been no recognizable loss on a reorganization but for "boot" received, no loss will be recognized.[28] Obviously, if the rationale of the instant case is followed, a transaction of the kind involved here would not be subject to the limitation of loss provision since it could not qualify as a reorganization by definition. Thus the loss would be fully recognizable at the time of the transaction.[29] In considering the possibilities of loss recognition, the Ninth Circuit observed that Congress seemed to have weighed the desirable features of the limitation of gain provisions against the undesirable potentialities of the recognition of losses.[30] The court

25. The "solely" provision could be deemed to apply only to the 80% requirement. If this were true, it would seem that the owners of the 80% (or more) of the stock should not be able to receive "other consideration" for additional stock if the transaction were to qualify as a reorganization. However, the *Southwest Consolidated* case would seem to be controlling even here, since at the time of the Controversy (B) and (C) of Section 112(g)(1) of the Int. Rev. Code of 1939 were combined, even though the *Southwest Consolidated* case was decided on what would have been Section 112(g)(1)(C) of the Int. Rev. Code, which did not have the 80% requirement. See Howard v. Commissioner, 238 F.2d 943, 946 (7th Cir. 1956). See also Int. Rev. Code of 1939, § 112(g)(1)(B), (C).

26. See note 25 *supra*.

27. Int. Rev. Code of 1939, ch. 1, § 112(e), 53 Stat. 39, now INT. REV. CODE OF 1954, § 356.

28. *Ibid.*

29. Since the loss provision is limited to certain enumerated sections, as is true with gains (see note 8 *supra*), a small amount of cash would take the transaction out of the definition of reorganization. Hence, the provision would not be applicable to a transaction of this kind.

30. Commissioner v. Turnbow, 286 F.2d 669, 674 (9th Cir. 1960).

then added that to permit the possibility of tax avoidance through recognition of losses to control the construction of the limitation of gain provision would be to overrule the apparent judgment of Congress on this question.[31]

Although the adoption of the rationale of the instant case might well result in the conversion of what would otherwise be legitimate reorganizations into transactions in which losses would be currently recognizable, it would seem that the legislative history soundly supports the instant decision. If Congress has constructed this provision in such a manner as to permit its abuse, the correction should be made by the Congress, not by judicial fiat.

Martin Smith, Jr.

INSURANCE — AUTOMOBILE LIABILITY INSURANCE — "TEMPORARY SUBSTITUTE" PROVISION — WITHDRAWN FROM NORMAL USE

Plaintiff sought to recover damages resulting from an accident in which defendant's insured was involved. Defendant had issued a liability policy on a family car which was registered and insured in the wife's name. At the time of the accident the husband was driving the son's car, because the poor condition of the tires on the family car rendered its use on long trips hazardous. Despite the condition of the tires on the family car, the wife and son continued to use it to go a short distance to and from work. The insurer contended that the family policy issued to the wife did not provide coverage for the accident since the family car had not been withdrawn from normal use as required by the temporary substitute provision. The court of appeal held for the plaintiff, finding that the family car had been withdrawn from regular, normal use and that the son's automobile was a temporary substitute automobile covered by the policy issued on the family car. On appeal to the Louisiana Supreme Court, *held,* reversed, two Justices dissenting. The son's car was not a temporary substitute automobile because the insured's automobile had not been withdrawn from normal use as required by that provision.[1] *Fullilove v. United States Casualty Co.*, 125 So.2d 389 (La. 1960).

31. *Id.* at 675.

1. It appears that the opinion did not consider the question of breakdown to any appreciable extent. Before considering the question of withdrawal from normal use the court stated: "[T]ires being necessary to the operation of the