Fordham Law Review

Volume 17 | Issue 2 Article 4

1948

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COMMENTS

SPLIT-OFF AND SPLIT-UP REORGANIZATIONS

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Reorganizations generally are such complicated transactions that many attorneys and accountants are fearful of the tax consequences. Yet there is one type of reorganization, the need for which often arises, which should not result in detrimental tax consequences, if the proper precautions are taken. This is the "split-up" or "split-off" type of reorganization.

Suppose a corporate client owns a chain of theatres, scattered throughout New York and Pennsylvania. All of the theatres are owned by one operating corporation. However, the comptroller of the corporation believes that operations could be carried on more efficiently if separate corporations were formed for each state's operations. The corporation's tax adviser immediately envisages the tax incidents of such a reorganization. Especially is this so because the assumption in this example is that all of the stock of the corporation is owned by members of one family, the father and three children each owning 25% of the stock. The corporation has a substantial surplus and a substantial good-will and if the transfer of assets is not tax-free, both to the corporation and to its stockholders, the sizable tax resulting could make serious and unnecessary inroads into its working capital.

Similar situations appear daily in a number of guises. It may be that a corporation has units in two or more states and that franchise and state income tax calculations are as a consequence made unnecessarily cumbersome. Or a corporation which manufactures two entirely different products may wish to separate these operations. Even casual thinking about business operations will reveal many good economic reasons for such organizational changes, and many varied situations may be suggested where the use of two or more corporations is preferable to the use of one. All such situations have a common element—the desire to split the existing corporation into parts. It is with this type of reorganization that this article is concerned.[1]

Essentially what is desired is a plan for the separation of the corporation into two corporate branches without the imposition of an immediate tax on the corporation or its stockholders and without a disadvantageous change of asset basis. Investigation indicates that two fundamental plans are feasible, one of which is at present somewhat the safer from the tax viewpoint.

Under one plan a *split-off reorganization* (with the surrender of stock) would be effected. The original corporation (which will hereafter be known as the X corporation) would transfer part of its assets to a new corporation—Y corporation—and immediately after the transfer X corporation or its stockholders would own a controlling interest in Y corporation. Under the other plan—*split-*

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1. Throughout this paper it will be assumed that only two operating corporations will be formed from the contemplated reorganization. However, the rules discussed herein are equally applicable to the formation of any number of corporations.

up reorganization—X corporation would tranfer part of its assets to Y corporation and its remaining assets to Z corporation and all of the stock of Y and Z corporations would be distributed to the stockholders of X corporation which would then be dissolved. No gain or loss would be recognized to X corporation or its stockholders in either situation.

Insofar as the terms of the statute are concerned both plans will qualify as a reorganization under Internal Revenue Code, Section 112 (g) (1) (D). No gain would be recognized to X corporation under Section 112 (b) (4), nor would gain be recognized to the stockholders of X corporation under Section 112 (b) (3). Both X corporation and its stockholders would retain their previous bases.[2]

In addition, both plans will apparently meet the two judicial tests that are applicable in such situations. First, the net effect of the reorganization will not be a distribution of a dividend (the test of the *Bazley* and *Adams* cases[3]) under Section 115 (g). Secondly, there will be a legitimate corporate purpose (under the test of the *Gregory* case[4]) or in the words of Judge Hand ". . . the readjustment shall be undertaken for reasons germane to the conduct of the venture in hand. . . ."[5]

2. INT. REV. CODE, § 113 (a) (6) & (7).

3. Bazley v. Commissioner, 331 U. S. 737 (1947), *rehearing denied and opinion amended,* 332 U. S. 752 (1947); Adams v. Commissioner, 331 U. S. 737 (1947), *rehearing denied and opinion amended,* 332 U. S. 752 (1947). See comment *infra* p. 254.

4. Gregory v. Helvering, 293 U. S. 465 (1935). In this case part of the assets of X corporation consisted of a block of stock in Y corporation. The sole shareholder of X corporation wanted to acquire the Y corporation stock personally without being subject to tax upon the full value of the stock as a dividend distribution. In order to do this a new corporation, Z, was formed and the Y stock transferred to it in exchange for all of Z's stock, which was then distributed to the sole shareholder of X corporation. Z corporation was then liquidated and the sole shareholder thus acquired the stock of Y corporation. Upon the subsequent sale of the stock of Y corporation a capital gain was claimed for the difference between the apportioned value of Z stock and the sale price of Y stock. The commissioner ignored the existence of Z corporation and taxed the shareholder as if she had received an ordinary dividend from X corporation of the Y stock. In sustaining the commissioner, the Supreme Court set up the now famous test of "business purpose," the restatement of which is found in Chisholm v. Commissioner, 79 F. 2d 14, 15 (C. C. A. 2d 1935), *cert. denied,* 296 U. S. 641 (1935):

". . . the incorporators adopted the usual form for creating business corporations; but their intent, or purpose, was merely to draught the papers, in fact not to create corporations as the court understood that word. That was the purpose which defeated their exemption, not the accompanying purpose to escape taxation; that purpose was legally neutral. Had they really meant to conduct a business by means of the two reorganized companies, they would have escaped whatever other aim they might have had, whether to avoid taxes, or to regenerate the world."

5. Helvering v. Gregory, 61 F. 2d 809, 811 (C. C. A. 2d 1934). This second test disapproves of the use of artificial steps in a plan of reorganization just to meet the literal requirements of the code. Thus in Robert R. McCormick, 33 B. T. A. 1046 (1936), a corporation was created for the sole purpose of passing a dividend to the stockholders of the transferor corporation. The board, following the *Gregory* decision, held that a taxable dividend had been distributed. Again in Morgan v. Helvering, 117 F. 2d 334

I. Split-Off Reorganizations

In the example given, X corporation, it will be assumed, is to retain the New York theatres (approximately 40% of the total assets) and transfer the Pennsylvania theatres (the remaining 60%), together with their proportionate share of the assets, liabilities, capital and surplus to Y corporation in exchange for all of its stock. This stock will be distributed pro rata to the stockholders of X corporation, and as a final step, in exchange therefore, the stockholders of X corporation, will surrender, pro rata, approximately 60% of their stock for cancellation.

A. Resulting Status after Reorganization

Net Assets:

X corporation will retain approximately 40% of its present net assets plus a proportionate share in the surplus.

Y corporation will acquire approximately 60% of the present net assets of X corporation plus a proportionate share in the surplus.

Stock:

Stockholders of X corporation will retain 40% of their present share holdings in X corporation, plus their pro rata share in all of the stock of Y corporation.

Bases:

They will remain the same for corporate assets. There will be no net change affecting stockholders.

B. History

In the historical background of the section of the law dealing with split-off reorganizations lies a major part of the uncertainty surrounding such reorganizations today.

The state of the law prior to 1924 was expressed as follows in a report of the Ways and Means committee:

"Under the existing law, if corporation A organizes a subsidiary, corporation B, to which it tranfers part of its assets in exchange for all the stock of corporation B, and distributes the stock of corporation B as a dividend to its stockholders without the surrender by the stockholders of any of their stock, then such a dividend is a taxable one. If, however, corporation A organizes two new corporations, corporations B and C, and transfers part of its assets to corporation B and part to corporation C, and the stockholders of corporation A surrender their stock and receive in exchange therefor stock of corporations B and C, no gain from the transaction is recognized. Thus, under the existing law, the same result, except as to tax liability, may be obtained by either of two methods; but if the first method set out above is adopted, the gain is taxable, while if the second method set out above is adopted, there is no taxable gain.

(C. C. A. 2d 1941), it was held that the exchange of stock pursuant to a purported plan of reorganization should be taxed as a distribution in partial liquidation since the apparent purpose of a series of transactions involving the formation of two new corporations and their consolidation into a new third corporation was to enable one of the stockholders to liquidate his stock in exchange for certain assets.

Subdivision (c) of the bill permits the reorganization to be accomplished in the first manner set out above without the recognition of gain. This method represents a common type of reorganization and clearly should be included within the reorganization provisions of the statute as long as the exemption under the present law is continued."[6]

To remedy the inequity of this situation, a series of new provisions were included in the 1924 Act.

Section 203 (b) (3) provided as follows:

"No gain or loss shall be recognized if a corporation a party to a reorganization exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

Section 203 (c) provided as follows:

"If there is distributed, in pursuance of a plan of reorganization, to a shareholder in a corporation a party to the reorganization, stock or securities in such corporation or in another corporation a party to the reorganization, without the surrender by such shareholder of stock or securities in such a corporation, no gain to the distributee from the receipt of such stock or security shall be recognized."

Section 203 (h) provided as follows:

"(1) The term 'reorganization' means . . . (B) 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 stockholders or both are in control of the corporation to which the assets are transferred. . . ."

By 1934, the Ways and Means Committee had concluded that:

"By this method corporations have found it possible to pay what would otherwise be taxable dividends, without any taxes upon their shareholders. The committee believes that this means of avoidance should be ended."[7]

As a result thereof Congress eliminated Section 203 (c) quoted above.

Thus in 1934 corporations were deprived of the tax-free use of split-offs without the surrender of stock. This eliminated a favorite "tax-saving" device —the transfer of operating assets of a corporation to a new corporation and the distribution of the remaining assets in liquidation of the old corporation. No longer could capital gain rates be availed of in preference to higher income tax rates.

With a fourteen year hindsight we can now see that legislative change was unnecessary. But in 1933 the implications of the *Sansome* case[8] were not evident and the *Gregory* case was still in the judicial process. The latter had been decided adversely to the Government in the Board of Tax Appeals and reversed by the Second Circuit with the Supreme Court still to be heard from.

With that background in mind the Treasury late in 1933 recommended that Section 203 (c) be repealed. Since that section had only dealt with the problem of split-off reorganizations *without* the surrender of stock, its repeal did not pro-

6. H. R. REP. No. 179, 68TH CONG., 1ST SESS. 14 (1924).

7. H. R. REP. No. 704, 73RD CONG., 2D SESS. 13 (1934).

8. Commissioner v. Sansome, 60 F. 2d 931 (C. C. A. 2d 1932), *cert. denied*, 287 U.S. 667 (1932).

hibit the tax-free use of split-offs *with* the surrender of stock. Nor was there any prohibition prior to 1924 when Section 203 (c) was inserted into the law.

Since split-offs *with* surrender of stock were not prohibited and since the express wording of Section 112(g)(1)(D) seems to provide for split-offs, the conclusion to be drawn is that split-offs *with* surrender of stock were intended to be treated in the same fashion as split-up reorganizations are treated. Unfortunately no definite stand has been taken by the Internal Revenue Bureau on that issue and as a result tax practitioners have, we believe unnecessarily, avoided this type of reorganization in favor of the split-up reorganization.

Currently an attempt is being made to clarify the situation. With the refinements of the *Sansome* and *Gregory* cases available, the House Ways and Means Comittee now has suggestions for legislation[9] before it which will specifically exempt from tax split-offs without the surrender of stock. There is no reason why this provision should not become law.

C. *Discussion of the Law*

Exchanges under two subdivisions of the Code are involved in a split-off reorganization:

(1) Under Section 112 (b) (3) "stock or securities in a corporation a party to a reorganization are, in pursuance of its plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

(2) Under Section 112 (b) (4) "a corporation a party to a reorganization, exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."

(1) Section 112 (b) (3)

First let us consider an exchange under Section 112 (b) (3) by analyzing its component parts. The requirements as stated by the section are:

(1) That there be a reorganization (as defined by Section 112 (g) (1)).

(2) That both X and Y corporations must be parties to the reorganization (as defined by Section 112 (g) (2)).

(3) That action must be taken in pursuance of a plan of reorganization.[10]

(4) That the exchange must be limited to stock or securities.

The first requirement under Section 112 (b) (3) is that there be a reorganization as defined by Section 112 (g) (1). Six types are included. The only type applicable under facts necessarily assumed in a split-up or split-off reorganization is that listed under Section 112 (g) (1) (D). This subdivision covers 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 stockholders or both, are in control of the corporation to which the assets are transferred. The term

9. Legislation to accomplish this was introduced in the 80th Congress, and will without question be reintroduced in the 81st Congress which convenes on January 3, 1949.

10. There is no requirement that all of the stock or securities in the corporation must be exchanged, nor that all of the stockholders must make the exchange in order for those who do to come within this provision.

"control" here, means the ownership of 80% of the total voting stock and 80% of all other types of stock.[11] It is computed with reference to issued and not merely authorized though unissued stock[12] and is related only to stock ownership, having no bearing upon the actual control over the corporate affairs which a stockholder exercises through his vote.[13] It should be noted that the failure to satisfy the control requirements of this section does not always result in the recognition of a gain. In a situation requiring the avoidance of the control requirement, *e.g.*, separating the interests of one of the stockholders from X corporation completely, the transaction might be so planned that the interest received would have no fair market value and there would be no recognition of a gain.[14]

The phrase in the statute "immediately after the transfer" does not require a simultaneous exchange since it was not intended that questions of tax liability should be determined by the fact that the transfer of property (or stock) occurred on a different day from that of the transfer of stock[15] nor is there any requirement that the stock be held for any specified period of time.[16] On the other hand the conditions of "control immediately after transfer" will not be satisfied where there is a contract requiring the transfer of the shares to others upon receipt by the stockholders of the transferor corporation.[17]

A split-off reorganization thus meets all the requirements of Section 112 (g) (1) (D). Property is being transferred to another corporation (Y) and immediately after the transfer the stockholders of the original corporation (X) will be in complete control of Y corporation. The judicial precedents are in accord with this viewpoint.[18]

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11. See INT. REV. CODE § 112 (h).

12. Louangel Holding Corp. v. Anderson, 9 F. Supp. 550 (S.D.N.Y. 1934); Ethel Gary, 18 B. T. A. 1204 (1930), *acquiescence,* IX-2 CUM. BULL. 22 (1930).

13. Kimbell-Diamond Milling Co., 10 T. C. 7 (1948), *acquiescence,* 5 P-H 1948 FED. TAX SERV. ¶ 76, 259 (1948); Federal Grain Corp., 18 B.T.A. 242 (1929).

14. Helvering v. Tex-Penn Oil Co., 300 U.S. 481 (1937); Perry v. Commissioner, 152 F. 2d 183 (C.C.A. 8th 1945); State Street Trust Co. v. United States, 37 F. Supp. 846 (D.C. Mass. 1941), *aff'd,* 124 F. 2d 948 (C.C.A. 1st 1942).

15. West Texas Refining & Development Co., 25 B.T.A. 1254 (1932), *aff'd* (on this point), 68 F. 2d 77 (C.C.A. 10th 1933).

16. Keen & Woolf Oil Co. v. Commissioner, 49 F. 2d 45, (C.C.A. 5th 1931) (arrangements for sale made immediately after); American Compress & Warehouse Co. v. Bender, 70 F. 2d 655 (C.C.A. 5th 1934), *cert. denied,* 293 U.S. 607 (1934) (sale five days later); C. T. Investment Co. v. Commissioner, 88 F. 2d 582 (C. C. A. 8th 1937).

17. Case v. Commissioner, 103 F. 2d 283 (C. C. A. 9th 1939); Schumacher Wall Board Corp., 33 B. T. A. 1211 (1936), *non-acquiescence,* XV-2 CUM. BULL. 45 (1936), *aff'd,* 93 F. 2d 79 (C.C.A. 9th 1937), *no cert. by Gov't,* 1 P-H 1938 FED. TAX SERV. ¶ 4.28 (1938); Hazeltine Corp., 32 B. T. A. 110 (1935), *aff'd* (on this issue), 89 F. 2d 513 (C. C. A. 3d 1937).

18. Commissioner v. Kolb, 100 F. 2d 920 (C.C.A. 9th 1938), *no. cert. by Gov't,* 1 P-H 1939 FED. TAX SERV. ¶ 4.22 (1939); Toklan Royalty Corp. v. Jones, 58 F. Supp. 967 (W.D. Okla. 1944), *dismissed by stipulation,* 147 F. 2d 856 (C. C. A. 10th 1945); Bremer v. White, 10 F. Supp. 9 (D.C. Mass. 1935); Estate of John B. Lewis, 6 T.C. 455 (1946), *appeal by taxpayer vacated,* 160 F. 2d 839 (C.C.A. 1st 1946), *remanded,* 10 T.C. 1080 (1948);

Under Section 112 (b) (3) it is necessary that both corporations be parties to the reorganization as defined in Section 112 (g) (2):

"The term 'a party to a reorganization' includes a corporation resulting from a reorganization and includes both corporations in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another."[19]

No question has been raised as to the applicability of this section to split-up or split-off reorganizations.

The third requirement under Section 112 (b) (3) is that there be a plan of reorganization. While this does not mean that the plan must be in writing,[20] the safest method of handling a reorganization is to draw up the complete plan, and have it adopted at a corporate meeting.[21] Once the plan is adopted it is necessary to follow it closely.[22]

One of the advantages of setting up the plan by that method is that once it is formally established, if delay is necessary in the distribution of stock, it will not be material.[23]

(a) Necessity for Surrender of Stock

Lastly under Section 112 (b) (3) there must be an exchange of stock or securities. In the hypothetical situation used here, the surrender of approximately 60% of the stock of X corporation for all of the stock of Y corporation is called for. The actual surrender of the stock in exchange for new stock or securities seems to be important, and this is a detail that all reorganizational planners should scrupulously observe.

It is difficult to understand what practical difference there is between a man owning, say, 200 shares of an outstanding one thousand share common stock issue, and his owning, (after a split-off of 60% of the assets) 80 shares of an outstanding 400 share common stock issue. But the requirement that stock be surrendered is specifically stated in U. S. Treas. Reg. 111, Section 29.112 (g)-5 and should not be passed off with an indifferent shrug.

W. N. Fry, 5 T. C. 1058 (1945); Roosevelt Investment Corp., 45 B. T. A. 440 (1941), *acquiescence*, 1941-2 CUM. BULL. 11; Julia S. Dillard, P-H 1945 T C MEM. DEC. SERV. ¶ 45,354 (1945).

19. See also U. S. TREAS. REG. 111, § 29.112(g)-2 (1941).

20. U. S. TREAS. REG. 111 § 29.112(g)-2 (1941); Hortense A. Menefee, 46 B. T. A. 865 (1942), *acquiescence*, 1942-1 CUM. BULL. 12; J. M. Harrison, Inc., 30 B. T. A. 455 (1934), *acquiescence*, XIII-2 CUM. BULL. 9 (1934).

21. C. T. Investment Co. v. Commissioner, 88 F. 2d 582 (C. C. A. 8th 1937); W. N. Fry, 5 T. C. 1058 (1945); Edison Securities Corp., 34 B. T. A. 1188 (1936), upheld a preliminary agreement which had not been expressed in a corporate resolution.

22. William Hewitt, 19 B. T. A. 771 (1930), *dismissed*, 76 F. 2d 1011 (C. C. A. 8th 1935), held that an individual stockholder who negotiated an exchange of his stock on a basis different from that of the plan did not make the exchange pursuant to the plan and consequently was subject to tax.

23. Philip W. McAbee, 5 T. C. 1130 (1945), *acquiescence*, 1946-2 CUM. BULL. 4; W. N. Fry, 5. T. C. 1058 (1945); D. W. Douglas, 37 B. T. A. 1122 (1938), *non-acquiescence*, 1938-2 CUM. BULL. 42.

Some relief from the necessity of physically surrendering stock is provided, however. If the par value of the stock is reduced, it does not seem to be necessary to turn in the old certificates.[24] Wherever possible, though, even in such instances, caution would seem to dictate an exchange of securities. There is no requirement that the stock received be similar to the stock surrendered.[25]

(b) Necessity for Surrender Pro Rata

If surrender of stock is a practical necessity, must stock be turned in pro rata or is there some latitude allowable? U. S. Treas. Reg. 111, Section 29.112 (g)-5 sheds no light on the manner in which stock in a transferor corporation must be surrendered where only a portion of its assets are to be transferred. It should be remembered, however, that,

"The purpose of the reorganization provisions of the Internal Revenue Code is to except from the general rule certain specifically described exchanges incident to such readjustments of corporate structures, made in one of the particular ways specified in the Code, as are required by business exigencies, and which effect only a readjustment of continuing interests in property under modified corporate forms. . . . The Code recognizes as a reorganization the change (made in a specified way) from a business enterprise conducted by a single corporation to the same business enterprise conducted by a parent and a subsidiary corporation. . . . "[26] That is the fundamental basis upon which the recognition of a gain is deferred to a future date.

Of course, the stockholders in the transferor corporation (X corporation) have interests in the combined assets in proportion to their holdings of stock. As interpreted by the regulations the Code provides not only for a readjustment in those combined assets but at the same time requires continuity of interest. The transferor corporation or its stockholders must receive at least 80% of the stock of the transferee corporation to satisfy the requirement. Neither the Code nor the decisions are specific as to the percentage of stock ownership which must be retained in the transferor corporation. One thing is certain, at least 80% of the transferor corporation must be retained. It is to be presumed that at least a like requirement is necessary for the transferor as well, *i.e.*, a readjustment of 20% in the control of the stock of the transferor corporation should be possible while remaining within the shelter of the reorganization provisions.[27] Thus a strictly proportionate surrendering of stock by the stockholders of the transferor corporation would appear to be unnecessary.

The case law in the field of "split-off" reorganizations reveals that there have been few attempts to revise control in the transferor corporation except by the complete elimination of one or more of the stockholders in exchange for complete control of the assets of the transferee corporation and the courts

24. W. N. Fry, 5 T. C. 1058 (1945).

25. Capento Securities Corp., 47 B. T. A. 691 (1942), *aff'd*, 140 F. 2d 382 (C. C. A. 1st 1944).

26. U. S. TREAS. REG. 111, § 29.112(g)-1 (1944).

27. That would appear to be the outermost limit possible.

have held uniformily that such readjustments are *not* protected by the exemption provisions.[28]

Logically the recapitalization cases should serve as guiding lights at this point since they merely contemplate a "reshuffling of the capital structure within the framework of an existing corporation. . . . "[29] But the courts have never required a continuity of proprietary interests as they have in other types of reorganization cases[30] although there are indications to the contrary.[31]

The possibility of readjusting interests in the transferor corporation was recognized in the case of *Weicker v. Howbert*.[32] In that case more than 90% of the stock of A corporation was owned by the taxpayer and his wife. B corporation was organized to receive a portion of the assets of A corporation in exchange for all the stock of B corporation. Thereupon the taxpayer exchanged a portion (amount not mentioned) of his stock in A corporation for 26% of the stock of B corporation. His wife exchanged all except one qualifying share in A corporation for the remainder of the stock of B corporation. The court, resting its refusal to recognize the transaction as an exempt reorganization on the lack of a continuity of interest, pointed out that the wife as a stockholder in A corporation would have to retain something more than a qualifying share in view of the fact that she was receiving a controlling interest in B corporation. Beyond the *Weicker* case there is little in the way of judicial assistance and consequently consideration must be given to Sections 115 (g) and 115 (c) to determine where the line is drawn between a tax-free exchange, a taxable dividend and a partial liquidation.

Primarily Section 115 (g) of the Code and Section 29.115-9 of Regulation 111 are aimed at the cancellation or redemption of stock which is "essentially equivalent to the distribution of a taxable dividend" and is distributed out of earnings or profits. It is clear at this time that the applicability of this section depends upon the net effect of the distribution and not the motives and plans of the taxpayer.[33] The section has been applied recently to the *Adams*, *Bazley* and *Heady* cases,[34] all of which involved an exchange of stock for stock plus debenture bonds as a part of a recapitalization. On the other hand, its applica-

28. See discussion under Section 115(c) page 255. The question may still be raised, however, as to the effect of an elimination of a stockholder owning less than 20% of the stock. It may be that such an elimination is permissible.

29. Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202 (1942).

30. LeTulle v. Scofield, 308 U. S. 415 (1940); Arthur J. Hooks, P-H 1944 TC MEM. DEC. SERV. ¶ 44,284 (1944).

31. United Gas Improvement Co. v. Commissioner, 142 F. 2d 216 (C. C. A. 3d 1944), *cert. denied*, 323 U. S. 739 (1944).

32. 103 F. 2d 105 (C. C. A. 10th 1939).

33. Smith v. United States, 121 F. 2d 692 (C. C. A. 3d 1941); Hirsch v. Commissioner, 124 F. 2d 24 (C. C. A. 9th 1941).

34. Adams v. Commissioner, 331 U. S. 737 (1947), *rehearing denied and opinion amended*, 332 U. S. 752 (1947); Bazley v. Commissioner, 331 U. S. 737 (1947), *rehearing denied and opinion amended*, 332 U. S. 752 (1947); Heady v. Commissioner, 162 F. 2d 699 (C. C. A. 7th 1947).

bility has been denied in an exchange of common for common stock[35] and in the exchange of preferred for other types of preferred stock[36] and like situations.[37]

The Court in the *Bazley* case specifically rested its decision on the fact that the net effect of the distribution of the debenture bonds was to distribute to the petitioner a substantial segment of the previous earnings of the corporation and at the same time allow the corporation to get interest deductions for tax purposes. The *Bazley* case could be dismissed summarily if it were not for a footnote in that case pointing out that, in the application of the test of whether a dividend has been distributed, it is immaterial whether the reorganization involves a recapitalization or an exchange of stock or assets of corporations.

If it is assumed that such transactions must meet the test of Section 115 (g), there can be little doubt that they do. The net effect of a split-off reorganization will be to divide the original shares of stock in X corporation into two segments, one representing the interest of the stockholders in X corporation and the other representing their interest in Y corporation. The total book value of the combined shares of stock in both corporations will be equal to the book value of the shares in X corporation before the transfer. The stockholders will have received the equivalent of their previous holdings. Their interest will be represented by different symbols. This transaction will rest on considerably more support than the mere bookkeeping transaction made use of in the *Adams* case, and can be supported by valid business reasons.

The distinction between a distribution in liquidation and an ordinary dividend is often difficult to make.[38] Less difficulty is encountered where a liquidation is to be distinguished from a tax-free exchange. There may co-exist both a liquidation and a tax-free exchange. However, where the liquidation is essential to the reorganization, the non-recognition of gain provided for by the reorganization provisions will prevent the application of Section 115 (c).[39] That, however, does not mean that one or more of the stockholders can liqui-

35. Helvering v. Griffiths, 318 U. S. 371 (1943).

36. The Okonite Co., 4 T. C. 618 (1945), *aff'd*, 155 F. 2d 248 (C. C. A. 3d 1946), *cert. denied*, 329 U. S. 764 (1946).

37. Helvering v. Sprouse, 318 U. S. 604 (1943) (non-voting common for voting common and non-voting common); Strassburger v. Commissioner, 318 U. S. 604 (1943) (preferred for common); Louis Wellhouse, Jr., 3 T. C. 363 (1944), *acquiescence*, 1944 CUM. BULL. 29 (preferred for common); Jacob Fischer, 46 B. T. A. 999 (1942), *commissioner's appeal dismissed* 4 P-H 1943, FED. TAX SERV. ¶ 61,080 (C. C. A. 6th 1943) (common for common and preferred).

38. Clara Louise Flinn, 37 B. T. A. 1085 (1938) *acquiescense*, 1938-2 CUM. BULL. 11, gives the rule. See also Darrell, *Corporate Liquidations and the Income Tax*, 39 U. OF PA. L. REV. 907, 915 (1891).

39. Survaunt v. Commissioner, 162 F. 2d 753 (C. C. A. 8th 1947); Fisher v. Commissioner, 108 F. 2d 707 (C. C. A. 6th 1939), *cert. denied*, 310 U. S. 627 (1940); Helvering v. Winston Bros. Co., 76 F. 2d 381 (C. C. A. 8th 1935); Morley Cypress Trust, 3 T. C. 84 (1944), *acquiescence*, 1944 CUM. BULL. 20; Hortense A. Menefee, 46 B. T. A. 865 (1942), *acquiescence*, 1942-1 CUM. BULL. 12; Anna V. Gilmore, 44 B. T. A. 881 (1941), *acquiescence*, 1946-2 CUM. BULL. 2; Peck & Peck, 42 B. T. A. 651 (1940).

date his holdings for a segregated portion of the assets. Attempts to accomplish that result have ended in the taxing of the transaction as a distribution in partial liquidation.[40] Since a split-off reorganization entails a partial liquidation which is specifically provided for by subdivision D of Section 112 (g) (1) no difficulty is likely to arise at this point.

The problems in respect to receipt of stock are similar to the ones discussed above on surrender of stock. Code Section 112 (h) requires that the transferor or its stockholders receive an 80% control of the transferee corporation. The split-off reorganization satisfies this requirement by providing for the distribution of all the stock of Y corporation to the stockholders of X corporation.

A "split-off" reorganization also calls for such distribution pro rata. While unquestionably this is a safe method, the cases reveal that it is unnecessary. The *Weicker* case *dictum* so indicated, and in *Roosevelt Investment Corp.*[41] in a reorganization under the 1934 equivalent of Section 112 (g) (1) (D) the argument that disproportionate interests had been acquired as a result of the reorganization was not considered valid and the court pointed out that only Section 112 (b) (5) required acquisition of a proportional interest. More recently in *Toklan Royalty Corp. v. Jones,*[42] only 75% of the stockholders of the transferor corporation took stock in the transferee corporation and the transaction was held to be within the definition of control of Section 112 (h).

This line of cases is a strengthening factor and provides some leeway where required.

(2) Section 112 (b) (4)

In the early portions of this article, it was pointed out that two parts of Section 112 (b) were involved in a contemplated "split-off" or "split-up" reorganization. The discussions up to this point covered the ramifications of Section 112 (b) (3). The other subdivision involved is Section 112 (b) (4), which provides for the non-recognition of gain to a corporation which gives up property in a reorganization in exchange for stock in another corporation, a party to the reorganization.

No extended discussion of this section is necessary in view of its similarity to Section 112 (b) (3). At one point the Treasury did raise the issue that Section 112 (b) (4) should not apply where the stock of the transferee corporation was issued directly to the stockholders of the transferor corporation. But, in the case of *Clyde Bacon, Inc.*[43] the Tax Court held that the transfer was within the provisions of the section and cited the *Morley Cypress Trust* case[44] involving the same principle under subdivision (3). The acquiescence of the Government would seem to have laid this issue to rest.

40. Morgan v. Helvering, 117 F. 2d 334 (C. C. A. 2d 1941); Weicker v. Howbert, 103 F. 2d 105 (C. C. A. 10th 1939); Case v. Commissioner, 103 F. 2d 283 (C. C. A. 9th 1939).

41. 45 B. T. A. 440 (1941), *acquiescence,* 1941-2 CUM. BULL. 11.

42. 58 F. Supp. 967 (W. D. Okla. 1944), *dismissed by stipulation,* 147 F. 2d 856 (C. C. A. 10th 1945); *cf.* Sidney S. Munter, 5 T. C. 108 (1945), *rev'd,* 157 F. 2d 132 (C. C. A. 3d 1946), *rev'd,* 331 U. S. 210 (1947).

43. 4 T. C. 1107 (1945), *acquiescence,* 1945 CUM. BULL. 1.

44. 3 T. C. 84 (1944), *acquiescence,* 1944 CUM. BULL. 20.

(3) Accumulated Earnings and the Rule of the Sansome Case

Under the rule of the *Sansome* case,[45] Y corporation would start off with its proportionate share of the accumulated earnings of X corporation. Thus when a successor corporation reaches the point at which it wishes to pay dividends, there will be no question as to the character of the dividends.

In the *Sansome* case the doctrine was applied in a situation involving a true successor corporation. The question did not arise in a "split-off" reorganization until 1938 in the *Barnes* case[46] and has since been applied in the *McClintic* and *Mandel* cases,[47] but distinguished in the *Slover* case.[48] It was also distinguished in a case involving the introduction of new capital and a change in stock holdings[49] but has been held equally applicable where the transferor corporation possesses a deficit.[50]

The application of this doctrine may create some practical difficulties in making the split-off. But the determination of the portion of surplus applicable to the operations being transferred is primarily an accounting problem and should be handled as such. It is a wise precaution to settle these details and have the results integrated into the plan of reorganization. Not only does this add another element of strength to the plan, but it may be of aid in meeting possible future objections of creditors.

(4) The Business Purpose Doctrine

Ever since the *Gregory* case was decided in 1935 practitioners have had to tread carefully in reorganizations to avoid another major pitfall. It was there that the "business purpose" doctrine was enunciated. Justice Sutherland laid down the requirement that there be a legitimate *corporate* purpose[51] involved and not merely formal obedience to the requirements of the reorganization statute.

Much has been written on the "business purpose" doctrine, on its limitations and its ramifications.[52] Suffice it to say here, as a reminder, that the practitioner must consider the question carefully before consummating the reorganization. He must be sure that his "reasons" are not just window-dressing

45. Commissioner v. Sansome, 60 F. 2d 931 (C. C. A. 2d 1932), *cert. denied*, 287 U. S. 667 (1932).

46. Barnes v. United States, 22 F. Supp. 282 (E. D. Pa. 1938).

47. Estate of Howard H. McClintic, 47 B. T. A. 188 (1942), *remanded pursuant to stipulation in compromise*, 4 P-H 1943 FED. TAX SERV. ¶ 61,103 (C. C. A. 3d 1943); Stella K. Mandel, 5 T. C. 684 (1945).

48. Samuel L. Slover, 6 T. C. 884 (1946), *acquiescence*, 1946-2 CUM. BULL. 5.

49. Campbell v. United States, 144 F. 2d 177 (C. C. A. 3d 1944), *no cert. by Gov't*, 4 P-H 1944 FED. TAX SERV. ¶ 61,096 (1944).

50. Senior Investment Corp., 2 T. C. 124 (1943), *mod. on appeal pursuant to agreement*, 5 P-H 1947 FED. TAX SERV. ¶ 72,371 (C. C. A. 6th 1947).

51. Gregory v. Helvering, 293 U. S. 465 (1935).

52. See Lourie, *The Business Purpose Doctrine*, 25 TAXES 800 (1947); Spear, *"Corporate Business Purpose" in Reorganization*, 3 TAX L. REV. 225 (1947-8). Holzman, *"Ten Years of the Gregory Case,"* 79 J. ACCOUNTANCY 215 (1945); HOLZMAN, CORPORATE REORGANIZATIONS 275 (1948).

to disguise a dividend distribution—the Bureau has a well developed nose for such smoke screens.

There is no need to remind the careful practitioner of the importance of formally documenting all points, and keeping complete records in any reorganization. The file should be built up not only on the formal steps taken, but with proof to substantiate the business purpose.

II. Split-up Reorganizations

To effectuate a split-up reorganization, X corporation would transfer its New York theatres to Y corporation in exchange for all of the stock of Y corporation. The Pennsylvania theatres would be transferred to Z corporation for all of its stock. Pursuant to the plan of reorganization all of the stock of the Y and Z corporations would be distributed to the stockholders of X corporation in exchange for their stock. X corporation would then be dissolved.

Realistically, and in practical effect, the end results of a split-up reorganization and a split-off reorganization would be the same—there would be two corporations in either case owning all of the assets. Except for the fact that in the split-up a new corporation would be substituted for the original corporation, there is no real difference. Practical considerations will, in some instances, dictate the desirability of keeping the original corporation. In such an event, a split-off reorganization would be preferable.

The previous discussion of the legal aspects of "split-offs" is equally pertinent here. The only point needing further discussion is that of the relative tax safety of the two plans. At the present time, with tax safety in mind it would be wise to make use of the split-up reorganization. As indicated previously in this article, the authors believe that either plan should be acceptable (assuming, of course, a surrender of stock in the split-off reorganization). There is, however, a school of thought in the Bureau of Internal Revenue which has raised some question about the legality of split-offs. It is believed that this viewpoint is not the prevailing one. As indicated previously, it is not sustained by the legislative history of the statute, and the express wording of Section 112 (g) (1) (D) is contrary, but its existence should be taken into consideration in making a final choice. If the time factor is not a pressing one, and if the split-off seems preferable, it is usually wise to have the Bureau of Internal Revenue rule on the case.

Conclusion

In the case assumed at the outset the corporate client may be told that it may separate its New York theatres from its Pennsylvania theatres without disadvantageous tax consequences. This may be done at present in one of two ways, either by a split-up reorganization or by a split-off reorganization if there is a surrender of stock. If no other considerations intervene, a split-up reorganization is to be preferred over the split-off with surrender of stock, only because of the lesser likelihood of Treasury objection. With careful attention to all details, the preservation of a complete record of all steps taken, and the formalization of the record when necessary through corporate resolutions and agreements, a valid tax-free reorganization will be accomplished.