

1984

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### Recommended Citation

Michael L. Gobbo, *Reorganization Treatment of Acquisitions of Stock Savings and Loan Institutions by Mutual Savings and Loan Associations*, 52 Fordham L. Rev. 1261 (1984).

Available at: <https://ir.lawnet.fordham.edu/flr/vol52/iss6/13>

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# REORGANIZATION TREATMENT OF ACQUISITIONS OF STOCK SAVINGS AND LOAN INSTITUTIONS BY MUTUAL SAVINGS AND LOAN ASSOCIATIONS

## INTRODUCTION

The acquisition (mutual-stock acquisition) of a stock savings and loan institution (stock institution) by a mutual savings and loan association (mutual association) has received inconsistent treatment<sup>1</sup> under the reorganization provisions of the Internal Revenue Code (Code).<sup>2</sup> Specifically, the disagreement is whether mutual passbook account shares (mutual shares) received by the stock institution shareholders should be characterized as primarily-debt or primarily-equity instruments.<sup>3</sup> This is a result of the "hybrid" nature<sup>4</sup> of mutual shares, which represent both an ownership interest<sup>5</sup> in the association similar to stock, and a debt interest<sup>6</sup> similar to savings deposits.

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1. *Compare* Paulsen v. Commissioner, 716 F.2d 563, 569-70 (9th Cir. 1983) (merger of stock into mutual not a reorganization), *cert. granted*, 104 S. Ct. 1271 (1984) and Rev. Rul. 69-6, 1969-1 C.B. 104 (same) with West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 405 (6th Cir. 1974) (merger of stock into mutual a reorganization) and Everett v. United States, 448 F.2d 357, 360 (10th Cir. 1971) (same) and Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 972 (Ct. Cl. 1979) (same); see B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 14.11, at 14-21 & nn.25-26 (4th ed. 1979); Chappell, *Judicial View that S & L Passbook Accounts are not "Stock" Complicates Reorganization*, 44 J. Tax'n 372 (1976). Currently over \$20 million in tax revenues are at stake in more than 670 cases on different levels of appeal within the Internal Revenue Service. Wall St. J., Feb. 22, 1984, at 8, col. 2. The Supreme Court has granted certiorari on the issue. Paulsen v. Commissioner, 104 S. Ct. 1271 (1984).

2. I.R.C. §§ 354, 361, 368, 381 (1976). See generally B. Bittker & J. Eustice, *supra* note 1, ch. 14 (definition, treatment of and special problems in corporate reorganizations).

3. See Paulsen v. Commissioner, 716 F.2d 563, 566 (9th Cir. 1983) (debt characteristics overwhelmingly predominate), *cert. granted*, 104 S. Ct. 1271 (1984); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 411 (6th Cir. 1974) (mutual shares represent definite and material proprietary interest); Everett v. United States, 448 F.2d 357, 358-60 (10th Cir. 1971) (proprietary rights make mutual shares voting stock); Rocky Mountain Fed. Sav. & Loan Ass'n v. United States, 473 F. Supp. 779, 782 (D. Wyo. 1979) (same); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974-75 (Ct. Cl. 1979) (rejecting government's argument that mutual shares are debt).

4. See Paulsen v. Commissioner, 78 T.C. 291, 298 (1982), *rev'd on other grounds*, 716 F.2d 563 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974 (Ct. Cl. 1979); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-21.

5. West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 409 (6th Cir. 1974); Everett v. United States, 448 F.2d 357, 360 (10th Cir. 1971); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974 (Ct. Cl. 1979).

6. West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 409 (6th Cir. 1974); Everett v. United States, 448 F.2d 357, 360 (10th Cir. 1971); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974 (Ct. Cl. 1979).

In order to qualify as a tax-deferred reorganization,<sup>7</sup> the acquiring corporation must either continue the business of the acquiree or use a significant portion of the acquiree's assets.<sup>8</sup> In addition, the acquiree's shareholders must retain a continuing proprietary interest in the acquirer.<sup>9</sup> Receipt of an equity interest typically will satisfy this require-

7. Although these transactions are commonly referred to as tax-free reorganizations, in actuality they are tax-deferred reorganizations. See L. Solomon, *Corporate Acquisitions, Mergers and Divestitures* ¶ 74,001 (1983). No gain or loss is recognized at the time of the transaction. See *infra* notes 15-16 and accompanying text. The acquiree shareholder's adjusted basis in the property given up, however, is carried over to his interest in the acquiring corporation. I.R.C. § 358(a) (1976). At the corporate level, the adjusted basis of the assets in the hands of the transferor is carried over to the acquiring corporation. *Id.* § 362(b). The unrecognized gain will be taxed when the taxpayer ultimately disposes of the property, because taxable gain is computed by subtracting the taxpayer's adjusted basis in the property from the amount realized on the disposition. *Id.* § 1001(a).

8. Treas. Reg. § 1.368-1(d)(2) (1983); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.51, at 14-129 to 14-130; L. Solomon, *supra* note 7, ¶ 74,160, at 74,159-61; see Tarleau, "Continuity of the Business Enterprise" in *Corporate Reorganizations and Other Corporate Readjustments*, 60 Colum. L. Rev. 792, 792-99 (1960); see, e.g., *Bazley v. Commissioner*, 331 U.S. 737, 740 (1947) (new form of previous participation in an enterprise); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932) (continuity of interest in assets of business), *cert. denied*, 288 U.S. 599 (1933); *Standard Realization Co. v. Commissioner*, 10 T.C. 708, 715 (1948) (sale of assets after exchange destroys continuity); see also Treas. Reg. § 1.1002-1(c) (1983) (new enterprise is substantial continuation of the old). The acquirer need not continue the historic business of the acquiree, *Becher v. Commissioner*, 221 F.2d 252, 253 (2d Cir. 1955); *Bentsen v. Phinney*, 199 F. Supp. 363, 367 (S.D. Tex. 1961); see *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737, 743 (8th Cir. 1968), but must merely continue in a business utilizing the assets of the acquiree. L. Solomon, *supra* note 7, ¶ 74,160, at 74,159-61. One court has noted that "[a]ll that is required is that the [acquirer] receive and continue to use some minimum amount of the [acquiree's] assets." *Laure v. Commissioner*, 653 F.2d 253, 261 (6th Cir. 1981).

9. *Paulsen v. Commissioner*, 716 F.2d 563, 566 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409, 411 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 974 (Ct. Cl. 1979); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20. The judicially-created continuity of proprietary interest doctrine requires "a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, (2) that such retained interest represents a substantial part of the value of the property transferred." *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.) (footnote omitted), *cert. denied*, 342 U.S. 860 (1951); see *LeTulle v. Scofield*, 308 U.S. 415, 420-21 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir.), *cert. denied*, 288 U.S. 599 (1932). See generally B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-17 to 14-21, 14-27 to 14-28 (discussion of the development of the continuity of interest doctrine).

The regulations also require a plan of reorganization which "must be adopted by each of the corporations . . . and appear upon the official records of the corporation." Treas. Reg. § 1.368-3(a) (1983). See generally Manning, "In Pursuance of the

ment, while receipt of a debt interest typically will not.<sup>10</sup> Treatment of this transaction under the Code's reorganization provisions, therefore, is dependent on the characterization of a mutual share as debt or equity.<sup>11</sup>

This problem has arisen in two types of transactions. Pursuant to a statutory merger, the stockholders of a stock institution may, after tendering their stock, receive mutual shares in the acquiring mutual association.<sup>12</sup> Alternatively, the stock institution might transfer substantially all of its assets to the mutual association in exchange for mutual shares.<sup>13</sup> In either case, the mutual shares are issued in an

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*Plan of Reorganization*": *The Scope of the Reorganization Provisions of the Internal Revenue Code*, 72 Harv. L. Rev. 881, 885-96 (1959) (detailed discussion of the requirement of a plan of reorganization).

An additional judicial doctrine, now set out in the Treasury Regulations, that must be satisfied is that the underlying transaction be "required by business exigencies." Treas. Reg. § 1.368-1(b) (1983); see *Gregory v. Helvering*, 293 U.S. 465, 469 (1935) (must have some business or corporate purpose); *Wortham Mach. Co. v. United States*, 521 F.2d 160, 162-63 (10th Cir. 1975) (taxpayer must show a valid business purpose); *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) (sole motive cannot be to escape taxation), *cert. denied*, 338 U.S. 955 (1950); Treas. Reg. § 1.368-1(c) (1983) (necessary to conduct of the enterprises); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.51, at 14-127 (transaction must have a legitimate corporate purpose); L. Solomon, *supra* note 7, ¶ 74,165, at 74,161 (same).

10. *Paulsen v. Commissioner*, 716 F.2d 563, 566 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 974 (Ct. Cl. 1979); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20; see, e.g., *LeTulle v. Scofield*, 308 U.S. 415, 420-21 (1940) (bonds and cash not sufficient interest); *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (preferred stock a satisfactory interest); *Pinellas Ice & Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933) (short-term purchase-money notes insufficient).

11. *Paulsen v. Commissioner*, 716 F.2d 563, 566 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 974-76 (Ct. Cl. 1979); see B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20. Under the general definitions of the Code, "corporation" is defined to include "associations," I.R.C. § 7701(a)(3) (1976), shareholder to include "a member in an association," *id.* § 7701(a)(8), and stock to include "shares in an association," *id.* § 7701(a)(7). Mutual shares, therefore, are defined as stock under the Code.

12. *Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *First Fed. Sav. & Loan Ass'n v. United States*, 452 F. Supp. 32, 33 (N.D. Ohio 1978), *aff'd mem.*, 615 F.2d 1360 (1980); see *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979). In relevant part, a reorganization is defined as: "a statutory merger or consolidation [or] . . . the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . , of substantially all of the properties of another corporation." I.R.C. § 368(a)(1)(A), (C) (1976).

13. See *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 406 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 359 (10th Cir. 1971); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); I.R.C. § 368(a)(1)(C) (1976).

amount equal to the fair market value of the stock or assets transferred.<sup>14</sup> Reorganization treatment provides for nonrecognition of gain or loss on the exchange of stock at both shareholder<sup>15</sup> and corporate levels.<sup>16</sup> In addition, at the corporate level, the stock institution's tax attributes are carried over<sup>17</sup> to the acquiring mutual association. Contemporaneous taxation of the acquisition, at the corporate or shareholder level, can thwart an otherwise desirable business combination.

Part I of this Note demonstrates that a stock-mutual merger satisfies the continuity-of-business-enterprise requirement. Part II delineates the continuity-of-proprietary-interest requirement, examines the nature of mutual shares and concludes that the required interest is present in a mutual-stock acquisition. In addition, several safe harbor restrictions that can be placed on mutual shares in order to avoid a debt characterization are proposed.

### I. CONTINUITY OF BUSINESS ENTERPRISE

The reorganization provisions presume that after the transaction, "the new enterprise, the new corporate structure and the new property are substantially continuations of the old still unliquidated."<sup>18</sup> The principle underlying the shareholder provisions<sup>19</sup> is that an investor should not be taxed when his capital remains invested in the acquiring entity<sup>20</sup>—continuity of proprietary interest.<sup>21</sup> At the corpo-

14. See *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 406 (6th Cir. 1974) (\$200 par value stock exchanged for \$2,500 per share); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979) (transferors received accounts in the amount of \$56.36 per share of \$10 par value stock transferred).

15. I.R.C. § 354(a)(1) (1976) ("No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.").

16. *Id.* § 361(a) ("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.").

17. Section 381(a) of the Code states that "[i]n the case of the acquisition of assets of a corporation by another corporation . . . the acquiring corporation shall succeed to and take into account, [the corporate tax attributes described in section 381(c)] of the distributor or transferor corporation . . ." in a transfer to which section 361 applies. I.R.C. § 381(a) (1976). These items include the transferor's net operating losses, method of accounting, depreciation, and investment tax credit. *Id.* § 381(c).

18. *Treas. Reg. § 1.1002-1(c)* (1983); see *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520, 523 (7th Cir. 1982); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 939-40 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

19. I.R.C. §§ 354, 368 (1976).

20. See *Groman v. Commissioner*, 302 U.S. 82, 89 (1937); *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520, 523 (7th Cir. 1982); *Treas. Reg. § 1.1002-1(c)* (1983); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.01, at 14-6; E. Krader, S. Leimberg, A. Parker & M. Satinsky, *Stanley & Kilcullen's Federal Income Tax Law* 7-6 (1983).

21. See *supra* note 9.

rate level,<sup>22</sup> taxation is inappropriate when the transaction involves solely a change in the structure of the corporate entity<sup>23</sup>—continuity of business enterprise.<sup>24</sup>

If a transaction qualifies as a reorganization, the transferor corporation recognizes no gain or loss under section 361.<sup>25</sup> In addition, the tax attributes of the acquiree carry over to the acquiror under section 381.<sup>26</sup> This allows the acquiree to avoid recapture of certain previously beneficial tax deductions and credits.<sup>27</sup> A mutual-stock acquisition's failure to qualify as a reorganization results in immediate taxation of the gain on the transfer of assets as well as a significant tax liability triggered by recapture of the institution's reserve for bad debts.<sup>28</sup> The current cost of a taxable combination, therefore, may outweigh its potential benefits.

Section 361 applies to transactions in which the acquiree corporation either transfers its assets or merges with the acquiror.<sup>29</sup> Congress recognized that in either situation the acquiree corporation acts as a mere conduit: It transfers the consideration received from the acquiring corporation to its own shareholders.<sup>30</sup> Section 381 reflects a con-

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22. I.R.C. §§ 361, 368, 381 (1976).

23. *See Reef Corp. v. Commissioner*, 368 F.2d 125, 130 (5th Cir. 1966), *cert. denied*, 386 U.S. 1018 (1967); *King Enters. v. United States*, 418 F.2d 511, 515 (Ct. Cl. 1969); *Treas. Reg. § 1.1002-1(c)* (1983); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.01, at 14-4.

24. *See supra* note 9.

25. I.R.C. § 361(a) (1976).

26. *Id.* § 381.

27. *See supra* note 17.

28. *See West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47, 49-50 (9th Cir. 1961); *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134, 136 (S.D. Cal. 1963); *Citizens Fed. Sav. & Loan Ass'n v. United States*, 290 F.2d 932, 936 (Ct. Cl. 1961). Savings and loan institutions are allowed a deduction for losses on outstanding loans in computing their income. I.R.C. § 593(b) (1976). The deduction is based upon a percentage of the institution's taxable income for the year. *Id.* § 593(b)(2). This method results in an outstanding reserve for bad debts when the deductions taken exceed the actual amount of loans that have become uncollectable. This amount must be recaptured when the institution is sold. *See West Seattle Nat'l Bank v. Commissioner*, 288 F.2d 47, 49-50 (9th Cir. 1961); *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134, 136 (S.D. Cal. 1963); *Citizens Fed. Sav. & Loan Ass'n v. United States*, 290 F.2d 932, 936 (Ct. Cl. 1961). A taxable sale or disposition of property could also trigger recapture of depreciation, I.R.C. § 1245 (1976) and investment tax credit, *id.* § 47. Thrift institutions typically do not place a significant portion of their assets in depreciable property. *See Moody's Bank & Finance Manual*, a9, (Vol. 1, 1983) (less than 5% of industry's total assets are depreciable). Recapture of these items, therefore, is not as significant as recapture of the bad debt reserve, which is based on taxable income.

29. I.R.C. § 361 (1982).

30. S. Rep. No. 398, 68th Cong., 1st Sess. 16, *reprinted in* 1939-1 C.B. (pt. 2) 266, 277; B. Bittker & J. Eustice, *supra* note 1, ¶ 14.32, at 14-102.

gressional intent that the acquiring or successor corporation step into the "tax shoes" of the acquired corporation when the reorganized entities are economically integrated into a unified business enterprise.<sup>31</sup> This is precisely what occurs in a mutual-stock acquisition. The resulting mutual association is the economic integration of the two separate savings and loan enterprises. Both entities are thrift institutions carrying on the same business prior to the merger. The resulting entity continues to perform these functions following the merger. Congress intended that such transactions not be subject to taxation because the business is simply continuing under a modified corporate form.<sup>32</sup>

Moreover, the IRS has accorded reorganization treatment to mergers of mutual associations into stock institutions.<sup>33</sup> The sole difference

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A merger typically involves the absorption of the acquiree by the acquirer, B. Bittker & J. Eustice, *supra* note 1, ¶ 14.12, at 14-31; F. Davis, *Business Acquisitions Desk Handbook* 4 (2d ed. 1981); H. Henn, *Law of Corporations* § 346, at 713 (2d ed. 1970); see R. Stevens, *Handbook on the Law of Private Corporations* § 193, at 918 (2d ed. 1949), with the acquiree's shareholders becoming shareholders or creditors of the acquirer, B. Bittker & J. Eustice, *supra* note 1, ¶ 14.12, at 14-31 to 14-32, and is commonly referred to as an "A" reorganization, see I.R.C. § 368(a)(1)(A) (1976); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.12, at 14-32; F. Davis, *supra*, at 2.

An acquisition of assets under I.R.C. § 368 (a)(1)(C), typically referred to as a "C" reorganization, see B. Bittker & J. Eustice, *supra* note 1, ¶ 14.14, at 14-48; F. Davis, *supra*, at 18, involves the transfer of substantially all of the assets of the acquiree to the acquirer solely in exchange for voting stock of the acquirer. I.R.C. § 368(a)(1)(C) (1976); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.14, at 14-48; F. Davis, *supra*, at 18-19. The economic consequences of A and C reorganizations are similar, B. Bittker & J. Eustice, *supra* note 1, ¶ 14.14, at 14-48, because a liquidation of the acquiree typically follows a C reorganization, with the consideration received being distributed to its stockholders. 13 B. Fox & E. Fox, *Business Organizations*, § 4.04[1], at 4-59 (1983).

This consistent treatment of the two types of transactions allows the form of the transaction to be governed by business and legal considerations and not solely by tax consequences. It may be more desirable to acquire a corporation's assets because a merger may carry with it contingent and undisclosed liabilities of the acquiree. See B. Bittker & J. Eustice, *supra* note 1, ¶ 14.05, at 14-14; L. Solomon, *supra* note 7, ¶ 71,701, at 71,305. Additional non-tax factors affecting the form of a merger are the requirement for shareholder approval, *id.* ¶ 71,050, at 71,051, convenience, *id.* ¶ 71,250, at 71,151, the handling of unwanted assets, *id.* ¶ 71,300, at 71,151, and accounting considerations, *id.* ¶ 71,500, at 71,152.

31. S. Rep. No. 1622, 83d Cong., 2d Sess. 52 [hereinafter cited as 1954 Senate Report], reprinted in 1954 U.S. Code Cong. & Ad. News 4621, 4683; B. Bittker & J. Eustice, *supra* note 1, ¶ 16.10, at 16-15 to 16-17.

32. See *Reef Corp. v. Commissioner*, 368 F.2d 125, 130 (5th Cir. 1966), cert. denied, 386 U.S. 1018 (1967); *King Enters. v. United States*, 418 F.2d 511, 515 (Ct. Cl. 1969); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-18.

33. Rev. Rul. 69-646, 1969-2 C.B. 54, 55. This transaction is identical to a stock-mutual merger except for the form of the resulting enterprise. Each mutual shareholder exchanges his mutual shares for passbook accounts in the stock institution bearing the same withdrawal value as their mutual shares. *Id.* In addition, they receive stock in the institution based on their distributive share of the mutual association's undistributed earnings and appreciated assets. *Id.*

between this transaction and a mutual-stock acquisition is the organizational structure of the resulting entity—stock or mutual form. The substantive operations of the resulting enterprises are otherwise identical.<sup>34</sup> Congress intended the reorganization provisions to apply consistently and to “depend less upon the form of the transaction than upon the economic integration of two or more separate businesses into a unified business enterprise.”<sup>35</sup> At the corporate level, therefore, reorganization treatment should be applied to both transactions because the continuity of business enterprise requirement is satisfied.

Sections 361 and 381 apply jointly only to transactions classified as reorganizations.<sup>36</sup> A transaction cannot be treated as a tax-deferred reorganization at the corporate level and a taxable sale at the shareholder level. The continuity of proprietary interest requirement, therefore, must be examined to determine the appropriate characterization of the entire transaction.

## II. CONTINUITY OF PROPRIETARY INTEREST

A stock institution is a corporation organized under state law<sup>37</sup> and authorized to issue capital stock.<sup>38</sup> Stockholders hold the equity of a stock institution, while depositors of the institution are creditors. A mutual association, on the other hand, is organized pursuant to federal<sup>39</sup> or state banking laws<sup>40</sup> and does not issue capital stock.<sup>41</sup> The

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34. See H. Russell, *Savings and Loan Associations* 3 (1960). Both organizations are traditionally grouped together in discussions of the thrift industry. See C. Henning, W. Pigott & R. Scott, *Financial Markets and the Economy* 132-33 (2d ed. 1978) (stock and mutual institutions included in description of savings and loans); Vartanian, *The Restructuring Of Savings Institutions*, 39 *Bus. Law.* 827, 827-33 (1984) (discussing mergers of both types of institutions).

35. 1954 Senate Report, *supra* note 31, at 52, *reprinted in* 1954 U.S. Code Cong. & Ad. News at 4684; see B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-18; L. Solomon, *supra* note 7, ¶ 74,155, at 74,155.

36. I.R.C. §§ 361, 381 (1976); see *id.* § 368(a)(1) (defining reorganization).

37. *E.g.*, Kan. Stat. Ann. § 17-5201 (1981); Ohio Rev. Code Ann. § 1151.02 (Page 1968); Wash. Rev. Code Ann. § 33.08.030 (Supp. 1983); Wyo. Stat. Ann. § 13-6-101 (1977); see *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 972-73 (Ct. Cl. 1979); H. Russell, *supra* note 34, at 3.

38. *E.g.*, Kan. Stat. Ann. §§ 17-5402, 17-5421 (1981); Ohio Rev. Code Ann. § 1151.20 (Page 1968); Wash. Rev. Code Ann. § 33.48.030 (Supp. 1983); Wyo. Stat. Ann. § 13-6-202 (1977); see *Paulsen v. Commissioner*, 716 F.2d 563, 564 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 406 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 972-73 (Ct. Cl. 1979).

40. *E.g.*, Ala. Code § 5-16-4 (1981); Cal. Fin. Code §§ 5400-5403 (West Supp. 1984); Ohio Rev. Code Ann. § 1151.81 (Page 1968); Wash. Rev. Code Ann. § 33.08.030 (Supp. 1983).

41. *E.g.*, Ala. Code § 5-16-16 (1981); Cal. Fin. Code § 5109 (West Supp. 1984); Ohio Rev. Code Ann. § 1151.81 (Page 1968); Wash. Rev. Code Ann. § 33.04.005



association consists of the depositors of the institution who hold substantially all of the equity interest in the association as represented by mutual shares.<sup>42</sup> Each depositor holds a "hybrid" security.<sup>43</sup> He is both a creditor and an owner of the association. As an owner, the mutual shareholder possesses the right to vote,<sup>44</sup> the right to share in the earnings of the association,<sup>45</sup> and the right to share ratably in any liquidation proceeds.<sup>46</sup> As a creditor, he has a qualified right to liquidate his account at any time,<sup>47</sup> and in some jurisdictions, his claim may not be subordinated to that of a general creditor.<sup>48</sup> In addition, dividends paid to the shareholders are deductible in computing the

(Supp. 1983); *Paulsen v. Commissioner*, 716 F.2d 563, 564 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 406 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979).

42. Borrowers may be considered members of the association, *see* H. Russell, *supra* note 34, at 239, and granted voting rights, *e.g.*, 12 C.F.R. § 544.1(a)(4) (1983); Ala. Code § 5-16-13(e) (1981); Ohio Rev. Code Ann. § 1151.47.1 (Page 1968).

43. *Paulsen v. Commissioner*, 78 T.C. 291, 298 (1982), *rev'd on other grounds*, 716 F.2d 563 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 974 (Ct. Cl. 1979); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-21.

44. *E.g.*, *Paulsen v. Commissioner*, 716 F.2d 563, 564-65 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 781 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); *see* H. Russell, *supra* note 34, at 204.

45. *E.g.*, *Paulsen v. Commissioner*, 716 F.2d 563, 564-65 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); H. Russell, *supra* note 34, at 2.

46. *E.g.*, *Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); *see* H. Russell, *supra* note 34, at 2.

47. Mutual associations may require members to give notice before honoring any withdrawal request, 12 C.F.R. § 544.1(a)(6) (1983) (mutual association must honor request within thirty days), but this is infrequently invoked. *See* *West Side Fed. Sav. & Loan v. United States*, 494 F.2d 404, 411 (6th Cir. 1974) (by-laws require thirty days notice); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979) (accounts redeemable thirty days after request); *Capital Sav. & Loan v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979) (deferment of payment authorized by statute); C. Henning, W. Pigott & R. Scott, *supra* note 34, at 133 (payments to share-account holders could be delayed).

48. *Paulsen v. Commissioner*, 716 F.2d 563, 568 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984). It is doubtful, however, that a mutual shareholder will be given the same priority as a general creditor. *See infra* notes 99-104 and accompanying text.

taxable income of the association.<sup>49</sup> The "hybrid" nature of these instruments makes it difficult to determine whether the continuity of proprietary interest requirement has been satisfied.

### A. *The Nature of the Interest*

The continuity-of-proprietary-interest doctrine was developed by the courts to deny tax-deferred treatment to those transactions that satisfied the literal requirements of the Code but were essentially disguised sales.<sup>50</sup> The doctrine requires the acquiree's shareholders to obtain a material interest in the affairs of the post-acquisition enterprise.<sup>51</sup> This requirement is comprised of two elements: First, the acquired interest must represent a proprietary stake in the enter-

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49. I.R.C. § 591(a) (1976). A stock institution, on the other hand, is allowed to deduct interest paid to its depositors, *id.* § 163(a), but because it is a corporation, it may not deduct dividends paid to its shareholders, *see* B. Bittker & J. Eustice, *supra* note 1, ¶ 4.01, at 4-2.

50. B. Bittker & J. Eustice, *supra* note 1, ¶ 14.03, at 14-11; J. Scott, *Federal Income Taxation of Corporate Reorganizations and Divisions* § 5.2, at 93-94 (1972); L. Solomon, *supra* note 7, ¶ 74,151, at 74,155; Cohen & Freling, *Tax Aspects of Tax-Free Acquisitions*, in Practising Law Institute, *Tax, SEC and Accounting Aspects of Corporate Acquisitions 40-41* (1977); *see* United States v. Hendler, 303 U.S. 564, 566 (1938) (assumption and payment of transferor's liabilities constitutes boot); Cortland Specialty Co. v. Commissioner, 60 F.2d 937, 940 (2d Cir. 1932) (cash and short-term notes too much like a sale), *cert. denied*, 288 U.S. 599 (1933). Several other judicial doctrines have evolved limiting the application of the reorganization provisions, including: the continuity of business enterprise requirement, *see supra* note 9 and accompanying text; the step-transaction doctrine, *see infra* notes 94-95 and accompanying text; and the business purpose doctrine, *see supra* note 9.

51. *LeTulle v. Scofield*, 308 U.S. 415, 420 (1940); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 940 (2d Cir. 1932), *cert. denied*, 288 U.S. 599 (1933).

The continuity of proprietary interest requirement has been waived for reorganizations involving financially-troubled thrift institutions. I.R.C. § 368(a)(3)(D) (West Supp. 1983); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.20, at 14-21 (Supp. III 1983). The merger of savings and loans should be encouraged beyond financially-troubled institutions. This would enable thrifts to avert financial difficulties before the situation becomes critical and allow mergers to be consummated on competitive terms. During the early 1980's, the failure or near failure of thrift institutions was common. Fingleton, *The Thrifts*, *Forbes*, Jan. 3, 1983, at 78; *While Congress Fiddles, More Thrifts Burn*, *The Economist*, Feb. 27, 1982, at 73. Many ailing thrifts were forced to merge with larger thrifts on unfavorable terms. *Id.* Although many mutuals are currently seeking to merge into or convert into stock institutions, *see* Cieply, *The Thrifts*, *Forbes*, Jan. 2, 1984, at 62, in order to attract investment capital, this does not mean that mergers of stock institutions into mutual associations should not be encouraged. Such mergers result in operating efficiencies that may allow the resulting institution to survive. The merger may also result in a diversification of the resulting entity's loan portfolio. Vartanian, *supra* note 34, at 829. Diversification lessens the risk of insolvency caused by interest rate fluctuations. Mergers among thrifts, regardless of the pre-transaction form, therefore, should not be discouraged by tax considerations.

prise,<sup>52</sup> and second, the value of the proprietary interest must constitute a substantial part of the value of that which was transferred.<sup>53</sup>

The first prong of the continuity of proprietary interest doctrine can be satisfied only if the transferee receives an equity interest in the new enterprise.<sup>54</sup> The recipient need not, however, acquire an equity interest in the new enterprise identical to the interest transferred.<sup>55</sup> The receipt of common or preferred stock, whether voting or nonvoting, has been held to be sufficient when exchanged for common stock.<sup>56</sup> A material change in the substantive character of the transferor's original interest, such as a change from equity to debt, however, can cause the transaction to be characterized as a sale rather than a reorganization.<sup>57</sup> In a mutual-stock acquisition, the inquiry, therefore, must focus on the nature of the mutual share.

The second prong of the continuity doctrine is a quantitative test requiring that the equity portion of the consideration received represent a substantial part of the value of the consideration given up.<sup>58</sup>

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52. *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); *see LeTulle v. Scofield*, 308 U.S. 415, 420 (1940); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20.

53. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); *Miller v. Commissioner*, 84 F.2d 415, 417 (6th Cir. 1936); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20.

54. B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20; *see J. Scott, Corporate Reorganizations and Divisions* § 5.201, at 94 n.265 (1972); L. Solomon, *supra* note 7, ¶ 74,155.2, at 74,157.

55. *See Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 977 (Ct. Cl. 1979); 3 J. Merten, *Merten's Law of Federal Income Tax* § 20.59 (rev. ed. 1982).

56. *See John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (preferred stock, even though non-voting, represents a substantial proprietary interest); B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-20 (same); L. Solomon, *supra* note 7, ¶ 74,155.2, at 74,157 (same). In an asset acquisition under § 368(a)(1)(C), however, the transferee must receive voting stock. I.R.C. § 368(a)(1)(C) (1976).

57. *See, e.g., LeTulle v. Scofield*, 308 U.S. 415, 416, 420-21 (1940) (\$750,000 in bonds not a proprietary interest even though secured by the assets transferred in reorganization); *Roebbling v. Commissioner*, 143 F.2d 810, 811, 814 (3d Cir.) (100 year bonds not a proprietary interest, merely a creditor's interest), *cert. denied*, 323 U.S. 773 (1944); *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937, 938, 940 (2d Cir. 1932) (cash and short-term promissory notes do not satisfy the continuity of interest doctrine), *cert. denied*, 288 U.S. 599 (1933); *see L. Solomon, supra* note 7, ¶ 74,155.2, at 74,157.

58. *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 385 (1935); *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 334 (5th Cir.), *cert. denied*, 342 U.S. 860 (1951); L. Solomon, *supra* note 7, ¶ 74,155.1, at 74,156; *see LeTulle v. Scofield*,

The merger of a stock institution into a mutual association involves only one instrument—a mutual share. Consequently, the characterization of the share as debt or equity is determinative of the second prong of the test as well.<sup>59</sup>

## B. Characterization of Mutual Shares

### 1. The Equity Characteristics

With the exception of minimal voting rights granted to borrowers,<sup>60</sup> mutual shares represent the only proprietary interest in the mutual association.<sup>61</sup> The mutual shareholder has the right to participate in

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308 U.S. 415, 420 (1940). The Internal Revenue Service will issue a favorable ruling with respect to the continuity of proprietary interest requirement if 50% of the consideration received in an A reorganization is equity. Rev. Proc. 77-37, 1977-2 C.B. 568, 569. Less than fifty percent equity, however, has been held to be sufficient. *See, e.g.,* John A. Nelson Co. v. Helvering, 296 U.S. 374, 376 (1935) (38% preferred stock, 62% cash sufficient); Miller v. Commissioner, 84 F.2d 415, 418 (6th Cir. 1936) (25% stock, 75% cash sufficient). In a C reorganization, the voting stock given up by the acquiror must represent at least 80% of the fair market value of all the property being acquired. I.R.C. § 368(a)(2)(B) (1982).

59. *See, e.g.,* Paulsen v. Commissioner, 716 F.2d 563, 566-69 (9th Cir. 1983) (debt characterization, therefore, no continuity), *cert. granted*, 104 S. Ct. 1271 (1984); Everett v. United States, 448 F.2d 357, 359-60 (10th Cir. 1971) (valid reorganization, mutual shares characterized as voting stock); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 976 (Ct. Cl. 1979) (same).

As an alternative, the Internal Revenue Service has argued that even if the mutual shares are found to have sufficient equity characteristics to satisfy the continuity requirement, the taxpayers have not received solely voting stock or securities in exchange for their stock. They have instead received an impermissible amount of boot. Brief for Appellant at 26-27, Paulsen v. Commissioner, 716 F.2d 563 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *see* Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 977 (Ct. Cl. 1979). This implies a bifurcation of the mutual share into an equity interest and a debt interest. The courts have not accepted this approach and characterize the instrument as either debt or equity. *See* Paulsen v. Commissioner, 716 F.2d 563, 566 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 409 (6th Cir. 1974); Rocky Mountain Fed. Sav. & Loan Ass'n v. United States, 473 F. Supp. 779, 783 (D. Wyo. 1979); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 976 (Ct. Cl. 1979). Further, courts have not bifurcated the interests in securities in cases involving the deductibility of interest, holding that the instruments were either wholly debt or equity. *See, e.g.,* United States v. Snyder Bros., 367 F.2d 980, 981, 984 (5th Cir. 1966) (pro rata holding by stockholders of subordinated debentures held not to be indebtedness), *cert. denied*, 386 U.S. 956 (1967); Fellinger v. United States, 238 F. Supp. 67, 76-77 (N.D. Ohio 1964) (ten-year debentures held equity), *aff'd*, 363 F.2d 826 (6th Cir. 1966); B. Bittker & J. Eustice, *supra* note 1, ¶ 4.02, at 4-7.

60. *E.g.,* 12 C.F.R. § 544.1(a)(4) (1983) (borrowing member entitled to one vote); Ala. Code § 5-16-13(e) (1981) (same); Ohio Rev. Code Ann. § 1151.471 (Page 1968) (borrowers may be provided voting rights). *See supra* note 42.

61. Paulsen v. Commissioner, 716 F.2d 563, 569 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d

the profits of the association,<sup>62</sup> share in any liquidation proceeds,<sup>63</sup> and vote in elections for the board of directors and on other important business matters such as mergers.<sup>64</sup> These are the same rights traditionally associated with corporate stock ownership.<sup>65</sup> The ownership of mutual shares, however, also grants rights typically associated with debt instruments.<sup>66</sup> A mutual-stock acquisition, therefore, involves an exchange of a pure equity interest for an "equity plus" interest. The acquiree shareholders' proprietary investment is retained, and they are granted additional rights. These additional rights do not materially affect the continuity of a stockholder's proprietary rights and should not cause the transaction to be treated as a taxable sale.

Mutual shareholders possess one of the primary rights of an equity holder, the right to share in profits.<sup>67</sup> The payment of dividends to mutual shareholders is similar to the payment of dividends to stockholders of a stock institution. In both instances, dividends must be

404, 409 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 976 (Ct. Cl. 1979); see H. Russell, *supra* note 34, at 246.

62. *Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 360 (10th Cir. 1971); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); H. Russell, *supra* note 34, at 2.

63. *Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 360 (10th Cir. 1971); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); see H. Russell, *supra* note 34, at 2.

64. *Paulsen v. Commissioner*, 716 F.2d 563, 564 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 360 (10th Cir. 1971); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 781-82 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979); see H. Russell, *supra* note 34, at 204.

65. See B. Bittker & J. Eustice, *supra* note 1, ¶ 14.31, at 14-94 to 14-95; R. Harvey, *A Hand-Book on Corporation Law* 236-37 (1906); H. Henn, *supra* note 30, § 124, at 208; R. Stevens, *supra* note 30, § 91, at 413. Mutual shareholders have been held to have additional rights associated with stock ownership. See *Tcherepnin v. Knight*, 389 U.S. 332, 345 (1967) (mutual shareholders entitled to protection under the Securities and Exchange Act of 1934); *Fahey v. Mallonee*, 332 U.S. 245, 255 (1947) (right to bring stockholders' derivative actions).

66. See *supra* notes 47-48 and accompanying text.

67. *E.g.*, *Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 360 (10th Cir. 1971); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); H. Russell, *supra* note 34, at 2.

declared by the board of directors,<sup>68</sup> and may be limited when the entity lacks sufficient earnings.<sup>69</sup> Thus, dividends are contingent on management's ability to run the association profitably.

It has been argued that mutual shares, in reality, provide a steady rate of return<sup>70</sup> similar to a savings account, a debt instrument. This is based on the belief that competition will compel mutual associations to provide a return comparable to that paid on deposits in commercial banks and stock institutions.<sup>71</sup> While a comparable rate of return may indeed be paid, this reasoning ignores the true proprietary nature of a mutual share. In addition to receiving distributions based on the association's profits,<sup>72</sup> each mutual share represents an undivided interest in a proportionate share of the association's assets and undistributed profits, which will inure to the shareholders upon liquidation.<sup>73</sup>

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68. See 12 C.F.R. § 544.1(a)(10) (1983) (mutual association); H. Henn, *supra* note 30, § 318, at 630 (corporation); R. Stevens, *supra* note 30, § 99, at 443 (same).

69. See 12 C.F.R. § 563.14 (1983) (mutual association must limit distributions); Kan. Stat. Ann. § 17-5412 (1981) ("no dividends shall be declared except from the earnings and undivided profits of the association"); H. Henn, *supra* note 30, § 318, at 630 (corporation may make distributions only out of legally available funds); R. Stevens, *supra* note 30, § 100, at 448-49 (distributions generally limited when capital is impaired).

70. Paulsen v. Commissioner, 716 F.2d 563, 567 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984).

71. *Id.* at 567-68. In practice, this will probably be true. Equal rates of return, however, do not make investment instruments identical. In addition to this return, mutual shareholders may benefit from the undistributed earnings of the association. See *infra* note 73.

72. See *supra* note 45 and accompanying text.

73. See Paulsen v. Commissioner, 716 F.2d 563, 565 (9th Cir. 1983) (net earnings and any surplus), *cert. granted*, 104 S. Ct. 1271 (1984); Rev. Rul. 69-646, 1969-2 C.B. 54 (undistributed earnings of the association effectively distributed pro-rata in form of acquiror's capital stock). Mutual shareholders will not benefit from the association's undistributed earnings by redeeming their shares because the withdrawable value of the shares does not change. H. Russell, *supra* note 34, at 282. They will, however, benefit from such earnings in several situations. First, upon liquidation, each mutual shareholder is entitled to his pro-rata share of the remaining assets. *E.g.*, Paulsen v. Commissioner, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 409 (6th Cir. 1974); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 973 (Ct. Cl. 1979); see H. Russell, *supra* note 34, at 2. Second, should the association become acquired by a stock institution, mutual shareholders may receive, in exchange for their liquidation rights, either stock in the acquiror, see Rev. Rul. 69-646, 1969-2 C.B. 54, 55, or a pro-rata interest in a liquidation account in an amount equal to the net worth of the mutual association, see LTR 8,346,052 (Aug. 16, 1983); LTR 8,327,088 (Apr. 8, 1983). This account gives the mutual shareholders priority over stockholders in the event of a liquidation of the stock institution, to the extent of their interest in the account, and is reduced to reflect subsequent withdrawals from the savings accounts. See LTR 8,346,052 (Aug. 16, 1983); LTR 8,327,088 (Apr. 8, 1983). Third, in a mutual-to-stock conversion, the mutual shareholders receive an interest in a similar liquidation account. See LTR 8,333,098 (May 19, 1983); LTR 8,333,061 (May 18, 1983); LTR 8,327,044 (April 6, 1983); LTR 8,310,078 (Dec. 9, 1982).

It has been suggested that the value of these rights is speculative and immaterial because a solvent association is highly unlikely to liquidate.<sup>74</sup> This assertion, however, does not recognize that mutual shareholders also benefit from these rights if the association is converted into or acquired by a stock institution,<sup>75</sup> not an uncommon occurrence.<sup>76</sup> The liquidation rights, therefore, along with the right to share in the association's distributed and undistributed earnings, represent a proprietary interest in the mutual association similar to a stockholder's interest in a stock institution.

The right to participate in the management of the enterprise<sup>77</sup> is another indicator of the nature of the interest held by mutual shareholders. Mutual shareholders vote for directors and on other matters affecting the enterprise.<sup>78</sup> Their counterparts in a stock institution, the stockholders, vote in similar corporate elections.<sup>79</sup> The materiality of the mutual shareholder's voting rights has been questioned in two respects. First, in practice, many mutual shareholders sign proxies when they invest in the association, and thus it is argued that such voting rights are illusory.<sup>80</sup> This practice of voting by proxy, however, is no different than that used by many corporations.<sup>81</sup> Further, in either enterprise, the proxy is revocable.<sup>82</sup> Thus, the right to vote is no more illusory than that of a corporate stockholder. Second, the mutual shareholder's voting rights may be limited to a maximum number of votes, regardless of the number of shares owned.<sup>83</sup> While this reduces

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74. *Paulsen v. Commissioner*, 716 F.2d 563, 568 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984).

75. See *supra* note 73 and accompanying text.

76. *E.g.*, LTR 8,346,052 (Aug. 16, 1983) (stock acquiring mutual); LTR 8,327,088 (April 8, 1983) (same); LTR 8,333,098 (May 19, 1983) (mutual converting to stock); LTR 8,333,061 (May 18, 1983) (same); LTR 8,327,044 (April 6, 1983) (same); see Ciepely, *supra* note 51, at 62; Vartanian, *supra* note 34, at 828-29.

77. This is represented by the right to vote. See *supra* note 44 and accompanying text.

78. *E.g.*, 12 C.F.R. § 544.1(a)(4) (1983); Kan. Stat. Ann. § 17-5305 (1981); Wash. Rev. Code Ann. § 33.20.010 (West Supp. 1983).

79. H. Henn, *supra* note 30, § 189, at 363-64; R. Stevens, *supra* note 30, § 112, at 517-18.

80. *Paulsen v. Commissioner*, 716 F.2d 563, 567 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *York v. Federal Home Loan Bank Board*, 624 F.2d 495, 497 n.1 (4th Cir.), *cert. denied*, 449 U.S. 1043 (1980). See generally H. Russell, *supra* note 34, at 204 (discussing savings association proxies).

81. See H. Henn, *supra* note 30, § 196, at 381-82; R. Stevens, *supra* note 30, § 118, at 532.

82. See H. Henn, *supra* note 30, § 196, at 383 (corporations); H. Russell, *supra* note 34, at 206 (mutual associations); R. Stevens, *supra* note 30, § 118, at 533 (corporations).

83. 12 C.F.R. § 544.1(a)(4) (1983) (federal mutual association shareholders entitled to one vote per \$100 on deposit, limited to 50 votes); see *Paulsen v. Commissioner*, 716 F.2d 563, 567 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); West

the voting rights of a mutual shareholder, it does not materially affect the continuity of the acquiree stockholders' proprietary rights. The continuity-of-proprietary-interest doctrine does not require that the interest received be identical to the interest transferred,<sup>84</sup> and the receipt of nonvoting stock will satisfy the continuity requirement.<sup>85</sup> This limitation on voting rights, therefore, should not adversely affect the characterization of a mutual-stock acquisition as a reorganization.

The proprietary rights of a mutual shareholder arguably differ from those held by ordinary stockholders because they have a greater potential to be infinitely dilutable.<sup>86</sup> Any additional transfer of funds to the association increases the total number of shares outstanding. This increases the transferor's proportionate interest in the entity and reduces the relative interest of the other shareholders. This dilution of proportionate interest may also be encountered by a corporate stockholder. In the absence of preemptive rights,<sup>87</sup> a stockholder's interest would be diluted if the corporation issues and sells additional shares. In addition, federal law permits the board of directors to limit the amount of capital that may be accepted for deposit,<sup>88</sup> and thus, the number of shares outstanding. This has the effect of preventing dilution beyond acceptable limits. The proprietary interest of a mutual shareholder, therefore, is substantially similar to the proprietary interest of a corporate stockholder.

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Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 406 (6th Cir. 1974); Rocky Mountain Fed. Sav. & Loan Ass'n v. United States, 473 F. Supp. 779, 781 (D. Wyo. 1979); First Fed. Sav. & Loan Ass'n v. United States, 452 F. Supp. 32, 33 (N.D. Ohio 1978), *aff'd mem.*, 615 F.2d 1360 (6th Cir. 1980).

84. See *Helvering v. Minnesota Tea Co.*, 296 U.S. 378, 386 (1935); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 977 (Ct. Cl. 1979); 3 J. Merten, *supra* note 55, § 20.59, at 254.

85. *E.g.*, *John A. Nelson Co. v. Helvering*, 296 U.S. 374, 377 (1935) (preferred stock represents a definite and substantial interest in acquiring corporation); see *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 407 (6th Cir. 1974). This will not, however, satisfy the statutory "solely for all or a part of its voting stock" requirement of an asset acquisition. See I.R.C. § 368(a)(1)(C) (1976). The preferred stock would have to carry with it an unconditional right to vote. Cohen, *Tax-Free Acquisitions*, in *Practising Law Institute, Tax and Accounting Aspects of Corporate Acquisitions* 64, 73 (1972).

86. *Paulsen v. Commissioner*, 716 F.2d 563, 567 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984). On the other hand, they are infinitely inflatable because any redemption of mutual shares increases the remaining shareholders' proportionate interest in the association.

87. In many jurisdictions, the articles of incorporation may limit or deny preemptive rights. *E.g.*, Ky. Rev. Stat. Ann. § 271A.130 (Bobbs-Merrill 1981); Mo. Ann. Stat. § 351.305 (Vernon 1966); N.D. Cent. Code § 10-19-24 (1960); see H. Henn, *supra* note 30, § 127, at 215; R. Stevens, *supra* note 30, § 111, at 503.

88. 12 C.F.R. § 544.5(7)(e) (1983).



## 2. Debt Characteristics—Negating Their Effect

The analysis of a mutual-stock acquisition differs from that of a traditional reorganization because there is no change in interest. Rather, the acquiree shareholders receive rights in addition to their original proprietary rights. The stockholders become owners of the mutual association<sup>89</sup> just as they were before the transaction. This transfer of proprietary rights should be sufficient to satisfy the continuity requirement. The additional rights received, however, are typically associated with debt instruments. These rights may include the right to be treated as a general creditor upon liquidation<sup>90</sup> and the qualified right to liquidate their investments on demand.<sup>91</sup> As a result, the interest of the mutual shareholder may cross into the realm of a non-equity interest. The effect of these debt-like characteristics may be negated, and the likelihood of reorganization treatment increased, if proper restrictions are placed on the mutual shares as part of the merger agreement.

Mutual shareholders have a qualified right to liquidate their investments on demand. The savings and loan charter may allow the association to require that shareholders give at least thirty days notice of their intention to redeem their shares.<sup>92</sup> This restriction, however, is usually not imposed.<sup>93</sup> Although the right to liquidate does not make a mutual share the equivalent of a demand deposit, it does make the instrument similar to a thirty-day demand note. In order to avoid such a characterization, restrictions can be placed on the right to redeem mutual shares received in the merger. This restriction would ensure preservation of the ownership interest for a certain period of time. In addition, such a restriction avoids application of the step-transaction doctrine<sup>94</sup> which may collapse the exchange for mutual

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89. *Paulsen v. Commissioner*, 716 F.2d 563, 564 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 976 (Ct. Cl. 1979).

90. *See Paulsen v. Commissioner*, 716 F.2d 563, 568 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984). This right, however, may not have been correctly interpreted in *Paulsen*. *See infra* notes 99-104 and accompanying text.

91. *See supra* note 47.

92. 12 C.F.R. § 544.1(a)(6) (1983); *see, e.g., Paulsen v. Commissioner*, 716 F.2d 563, 565 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979).

93. *See West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Rocky Mountain Fed. Sav. & Loan Ass'n v. United States*, 473 F. Supp. 779, 782 (D. Wyo. 1979); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973 (Ct. Cl. 1979).

94. The step-transaction doctrine is another judicial limitation on reorganizations that emphasizes the substance of a transaction over its form. *See McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520, 524 (7th Cir. 1982); *Red-*

shares and subsequent redemptions into a single transaction,<sup>95</sup> resulting in a taxable sale.

Federal securities law requires that securities be held for at least two years to establish that they were purchased for investment and not resale.<sup>96</sup> Such a standard can be applied to a stock-mutual merger. An extended holding period implies that the mutual shares are held for investment and would rebut the argument that the acquiree's shareholders have "cashed in" their position. Time restrictions on the right to redeem mutual shares will ensure that the merger and subsequent redemptions of mutual shares are treated as separate transactions.<sup>97</sup>

Even if the shareholder were required to hold his shares for a specified period of time, he could effectively "cash in" his investment by borrowing against the shares.<sup>98</sup> Thus, restrictions should be placed on the ability to pledge the shares to prevent the shareholder from "cashing in" his investment.

Placing the mutual shareholder on an equal footing with general creditors militates against reorganization treatment. In *Paulsen v. Commissioner*,<sup>99</sup> the Court of Appeals for the Ninth Circuit interpreted prior California decisions as granting general creditor status to mutual shareholders upon liquidation.<sup>100</sup> This would represent a substantial change in the equity-risk position<sup>101</sup> of the investor potentially

ding v. Commissioner, 630 F.2d 1169, 1175 (7th Cir. 1980), *cert. denied*, 450 U.S. 913 (1981); Mintz & Plumb, *Step Transactions in Corporate Reorganizations*, 12 Inst. on Fed. Tax'n 247, 247 (1954).

95. See B. Bittker & J. Eustice, *supra* note 1, ¶ 14.51, at 14-131; J. Scott, *supra* note 54, § 5.203, at 101; L. Solomon, *supra* note 7, ¶ 74,176, at 74,162.

96. 17 C.F.R. § 230.144(d) (1983); see *United States v. Sherwood*, 175 F. Supp. 480, 483 (S.D.N.Y. 1959); D. Goldwasser, *The Practitioner's Comprehensive Guide To Rule 144*, at 199 (2d ed. 1978). Prior to the adoption of Rule 144, either a change-of-circumstances test was used to determine whether securities were purchased for investment, see D. Goldwasser, *supra*, at 33-35; Mandelstam, *How Long Must I Hold?*, 25 U. Miami L. Rev. 173, 179 (1970), or a flexible holding period standard, D. Goldwasser, *supra*, at 28-33, Mandelstam, *supra*, at 177-79.

97. The length of time between transactions, although not determinative, is one factor used by courts in determining the applicability of the step-transaction doctrine. See J. Rabkin & M. Johnson, *Federal Income, Gift and Estate Taxation* § 32.07, at 3252 (1983); L. Solomon, *supra* note 7, ¶ 74,176, at 74,162; Mintz & Plumb, *supra* note 94, at 249.

98. This persuaded the Ninth Circuit in *Paulsen v. Commissioner*, 716 F.2d 563 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984), to find that the stock institution shareholders had cashed in their investment. *Id.* at 568. In this case, the merger agreement authorized the shareholders of the acquiree to borrow against their mutual shares at preferred rates. *Id.* The mutual shares were found to be "essentially the equivalent of cash." *Id.* at 569.

99. 716 F.2d 563 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984).

100. *Id.* at 568.

101. A change in the risk associated solely with the nature of the investment represents a substantive change in the taxpayer's investment that may result in the

warranting taxation of the transaction. Upon closer examination, however, these decisions merely recognize that membership shareholders<sup>102</sup> in a stock institution, who are depositors with limited voting rights, have priority over the stockholders.<sup>103</sup> Membership shareholders are not subordinated to the claims of general creditors.<sup>104</sup> Therefore, mutual shareholders, even if treated as membership shareholders, would be subordinated to the claims of general creditors.<sup>105</sup> Even in a jurisdiction that grants mutual shareholders the same priority as general creditors,<sup>106</sup> the acquisition agreement can provide that the acquiree's shareholders will be subordinated to the claims of general creditors. The mutual-stock acquisition, therefore, should not result in a substantial change of the equity-risk position of the stockholder and should not affect the characterization of the mutual share.

Finally, dividends paid to mutual shareholders are deductible<sup>107</sup> in computing the taxable income of the association, just as interest on indebtedness is deductible.<sup>108</sup> It has been argued that this precludes classifying mutual shares as equity.<sup>109</sup> Such an argument ignores the rationale for the deduction. Mutual associations were originally exempt from income tax.<sup>110</sup> The exemption was removed by the Revenue Act of 1951<sup>111</sup> which simultaneously provided for the deduction.<sup>112</sup>

transaction failing to satisfy the continuity of proprietary interest requirement. *See id.* at 569; *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520, 523 (7th Cir. 1982); J. Scott, *supra* note 54, § 5.201, at 94.

102. Membership shareholders are members in a stock institution but have limited voting rights and have no right to the undistributed earnings of the institution. *See In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 141, 99 P.2d 251, 254 (1940).

103. *See Home Sav. & Loan Ass'n v. United States*, 514 F.2d 1199, 1207 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975); *In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 142, 99 P.2d 251, 254 (1940).

104. *See Home Sav. & Loan Ass'n v. United States*, 514 F.2d 1199, 1207 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975); *In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 142, 99 P.2d 251, 254 (1940).

105. *In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 142, 99 P.2d 251, 254 (1940); In other states, mutual shareholders are statutorily subordinated to the claims of general creditors. *See, e.g.*, Fla. Stat. Ann. § 665.0601 (West Supp. 1984); Va. Code § 6.1-195.14 (1979); Wash. Rev. Code Ann. § 33.20.010 (Supp. 1983).

106. *See Paulsen v. Commissioner*, 716 F.2d 563, 568 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984); Md. Fin. Inst. Code Ann. § 9.329 (1980).

107. I.R.C. § 591 (1976). In addition, it is argued that mutual shares are more like debt because the dividends received are not entitled to the dividend exclusion. *Id.* § 116(c)(1). Dividends from foreign corporations or regulated investment companies also do not qualify for the exclusion. *Id.* § 116(d). Therefore, this is not determinative as to whether a particular interest is debt or equity.

108. I.R.C. § 163 (1976).

109. *Paulsen v. Commissioner*, 716 F.2d 563, 567-68 (9th Cir. 1983), *cert. granted*, 104 S. Ct. 1271 (1984).

110. I.R.C. § 101 (Stand. Fed. Tax Rep. (CCH) ¶ 640A (1952)).

111. Ch. 521, § 313(a), 65 Stat. 452, 490; *see S. Rep. No. 781, 82d Cong., 1st Sess. 28, reprinted in 1951 U.S. Code Cong. & Ad. News 1969, 1996.*

112. Revenue Act of 1951, ch. 521, § 313(f), 65 Stat. 452, 491.

The purpose of the Act was to prevent the accumulation of tax-exempt income in mutual associations.<sup>113</sup> Accordingly, a deduction was granted for distributions made by mutual associations.<sup>114</sup> Thus, the deduction of dividends does not support the classification of the shares as debt.

Although mutual shareholders clearly retain a substantial interest in a mutual association, it is uncertain whether that interest is sufficiently similar to the stockholder's proprietary interest in a stock institution to qualify the transaction for reorganization treatment. Proper planning, however, increases the likelihood of favorable treatment.

#### CONCLUSION

A mutual-stock acquisition is not readily characterized as a tax-deferred reorganization because of the unique capital structure of mutual associations. The transaction should be accorded reorganization treatment because "the nature and extent of [the stockholder's] continued participation in the corporation's control, earnings, and assets, and the relationship of their interests to those of other shareholders and security holders after the transaction has been consummated"<sup>115</sup> remains unchanged. Further, by following the suggestions contained herein, the debt characteristics of mutual shares can be minimized to a point where they do not affect the continuity of the shareholders' investment interest. Mutual-stock acquisitions, therefore, should be found to satisfy the continuity of proprietary interest doctrine and thereby qualify as tax-deferred reorganizations.

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113. See *Midwest Sav. Ass'n v. Commissioner*, 75 T.C. 262, 266-67 (1980); *Hudson City Sav. Bank v. Commissioner*, 53 T.C. 70, 74-75 (1969).

114. See *Midwest Sav. Ass'n v. Commissioner*, 75 T.C. 262, 266-67 (1980); *Hudson City Sav. Bank v. Commissioner*, 53 T.C. 70, 74-75 (1969).

115. B. Bittker & J. Eustice, *supra* note 1, ¶ 14.11, at 14-18.