Washington Law Review

Volume 37 | Number 4

12-1-1962

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TURNBOW V. COMMISSIONER—REJECTION OF THE "BOOT" EXCEPTION TO A TYPE B REORGANIZATION?

The United States Supreme Court in *Turnbow v. Commissioner*[1] may have interpreted the *Internal Revenue Code* to preclude the receipt of "boot"[2] in a non-taxable, stock for stock reorganization.[3] Although the Court was interpreting the application of Section 112 of the 1939 *Code*, the decision may be decisive in the interpretation of the parallel sections in the 1954 *Code*.

Grover D. Turnbow owned all of the outstanding stock of International Dairy Supply Corporation. In 1952 he transferred all of his International stock to Foremost Dairies, Inc. In return he received 82,375 shares, a minority interest, in Foremost. The fair market value of the stock was $15 per share. He received, in addition, $3,000,000 cash. On his 1952 income tax return, Turnbow treated the transaction as a capital gain, but only to the extent that he received cash, or "boot." The Commissioner proposed a deficiency, contending that the whole gain was recognizable.

The case presents a problem of interpretation of three statutory sections which are part of the corporate reorganization provisions of the income tax law. Both the 1939 and 1954 *Codes* define such "reorganizations" in technical terms. The definitions are in paragraphs which happen to be designated by the capital letters *A, B, C, D, E* and *F*. In popular tax law parlance, the respective definitions are referred to as Type *A, B, C, D,* etc., reorganizations. Four types of reorganizations concern corporate combinations in which one corporation emerges as the "owner" of the businesses conducted previously by both. Thus, Type *A* refers to combinations created by statutory merger or consolidation; Type *B* to acquisitions by trading stock for stock; and Types *C* and *D* to acquisitions of assets in exchange for stock. Types *E* and *F* involve recapitalizations and mere changes in identity, form or place of organization of a corporation and have little relevance to the problem involved in *Turnbow*. The taxpayer in *Turnbow* attempted to establish his transaction as a Type *B* reorganization.

[1] 368 U.S. 337 (1961).

[2] Money or "other" property received as consideration in addition to the shares of stock in the corporation which was a party to the transaction. See, 3 MERTENS, FEDERAL INCOME TAXATION § 20.147 (1957).

[3] The tax bar has adopted the term "Type B reorganization" as a shorthand method of referring to a reorganization under the Internal Revenue Code of 1939, § 112(b)(3), which section was carried over into the 1954 *Code* as § 368(a)(1)(B).

The problem presented involves the interpretation of the following three statutory sections:

> (g) Definition of reorganization. As used in this section . . .
> (1) The term "reorganization" means . . . (b) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation;[4]

> Stock for stock on reorganization. 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.[5]

> Gains from exchanges not solely in kind. (1) If an exchange would be within the provisions of subsection (b) (1), (2), (3) or (5) or within the provisions of subsection (1), of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph or by subsection (1) to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.[6]

The first two of these sections clearly establish two propositions, first, that an exchange of shares in one corporation solely for controlling shares in another corporation is a reorganization and, second, that such a transaction results in no recognized gain for income tax purposes. Thus taxpayer Turnbow admittedly could have disposed of his controlling shares solely in exchange for shares of Foremost Dairies without incurring any immediate tax liability. Alternatively, the same result could have been accomplished by a statutory merger or consolidation which would have satisfied the requirements of a Type *A* reorganization.

Since the transaction was cast as a Type *B* reorganization the Commissioner's determination of a deficiency was appealed to the Tax Court. The Tax Court decided in Turnbow's favor.[7] In doing so it followed its own early decision in *Bonham v. Commissioner*[8] and the

[4] INT. REV. CODE OF 1939, § 112(g) (1).
[5] INT. REV. CODE OF 1939, § 112(b) (3).
[6] INT. REV. CODE OF 1939, § 112(c) (1).
[7] Turnbow v. Commissioner, 32 T.C. 646 (1959). Noted 73 HARV. L. REV. 1402 (1960).
[8] 33 B.T.A. 1100 (1936). (transfer of stock to a second corporation for cash and stock of the latter corporation: Held, § 112(c) (1) is applicable and the gain is limited to an amount not exceeding the cash payment.)

Seventh Circuit determination in *Howard v. Commissioner*.[9] Further, the Tax Court looked to its longstanding and continuous construction of Section 112(c) (1) and the regulations[10] promulgated under it as being determinative.[11] The court held that, "*but for* the cash received . . . the exchange would have met the 'solely' requirement of section 112(g) (1) (B) and fallen within section 112(b) (3)."[12]

On appeal to the Ninth Circuit that court placed heavy emphasis upon the legislative history of the 1934 amendment to Section 112(g) (1).[13] The court concluded:

> ". . . if the "solely for voting stock" requirement of (B) and (C) reorganizations is to be given the effect intended by Congress, § 112(c) cannot operate to render a stock-plus-boot acquisition a (B) or (C) reorganization through a disregard of the existence of boot. In the case before us, then, *the existence of boot prevents §112(g) (1) (B) from applying; since no reorganization exists, § 112(b) (3) cannot apply; § 112(c) is then also inapplicable.*"[14] (Emphasis added.)

Certiorari was granted in order to resolve the conflict between the Seventh and Ninth Circuits.[15] The Supreme Court based its affirmance

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[9] 238 F.2d 943 (7th Cir. 1956). The petitioners and other shareholders held 80.19% of all the shares. They received only voting stock in exchange for their shares. The other shareholders received cash for their shares. The court specifically held that § 112(b) (3) was inapplicable, but under § 112(c) (1) gain is recognized to the extent of the cash received. Since the taxpayers in question had received no cash they therefore had no recognized gain.

The decision was subjected to strong criticism, *i.e.*, "the interpretation . . . appears to make a shambles of the statutory requirements for a 'B' or 'C' reorganization . . . . [R]estrictions in these provisions in effect are abolished through that interpretation, and the position of the Court of Appeals seems to be of highly questionable validity." 3 MERTENS, FEDERAL INCOME TAXATION § 20.147 n.84a (1957).

[10] Especially Treas. Regs. 118 § 39.112(g)—4 "*Exchanges in reorganization for stock or securities and other property or money.* (a) If in an exchange of stock or securities in a corporation a party to a reorganization, in pursuance of the plan of reorganization, for stock or securities in the same corporation or in another corporation a party to the reorganization, there is received by the taxpayer other property (not permitted to be received without the recognition of gain) or money, then

(1) As provided in section 112(c) (1), the gain, if any, to the taxpayer will be recognized in an amount not in excess of the sum of money and the fair market value of the other property, ...

Example. A, in connection with a reorganization, in 1952, exchanges a share of stock in the X Corporation purchased in 1929 at a cost of $100 for a share of stock in the Y Corporation (a party to the reorganization), which has a fair market value of $90, plus $20 in cash. The gain from the transaction is $10 and is recognized and taxed as a gain from the exchange of property. . . ."

The Tax Court felt the regulations had been approved by Congress since they were of long standing and Congress had reenacted the Internal Revenue Code several times during their life. See Lykes v. United States, 343 U.S. 118 (1952), and Helvering v. Winmill, 305 U.S. 79 (1938).

[11] Turnbow v. Commissioner, 32 T.C. 646, 652 (1959).

[12] *Id.* at 652-53.

[13] Commissioner v. Turnbow, 286 F.2d 669, 672-674 (1960).

[14] *Id.* at 675.

[15] Turnbow v. Commissioner, 366 U.S. 923 (1961).

of the Ninth Circuit decision, not upon the legislative history[16] but upon a requirement that "an actual 'reorganization,' as defined in § 112(g) (1) and used in § 112(b) (3), must exist before § 112(c) (1) can apply thereto."[17] Thus the Court disposed of the case by a simple and *limited*[18] exercise of statutory construction and required a literal compliance with the statutory definition of a reorganization.

The prospective effect of *Turnbow* is to give vitality to the Commissioner's contention that § 356(a) will not carve out an exception to the "solely for stock" requirement of § 368(a) (1) (B) because these parallel sections were enacted in 1954 without substantial change from the 1939 *Code* sections. While the decision was expressly limited to the case before it,[19] the approach taken by the Court to the statutory interpretation problem will certainly carry a great deal of weight with courts which may be called upon in the future to analyze the interplay between § 356(a) and § 368(a) (1) (B).[20] This attitude will probably also carry over into the interpretation placed on the Type *C* reorganization in similar circumstances.[21]

The Supreme Court decision in *Turnbow* does leave several questions unanswered. (1) How limited is the holding?[22] (2) What effect will the legislative history of the *Internal Revenue Code* of 1954 have?[23] (3) To what extent will changes in the 1954 *Code* provisions be influ-

[16] Turnbow v. Commissioner, 368 U.S. 337, 344 n.8 (1961), "The legislative history, much of which is set forth in the opinion of the Court of Appeals, though tending to support our decision, *is inconclusive,* and no more can fairly be said of the Commissioner's Regulations. See Treas. Regs. 118, §§ 39.112 (c)-1(e), 39.112(g)-4, 39.112(g)-1(c)." (Emphasis added.) This note disposed of the argument advanced by the Tax Court based upon longstanding construction of the regulations. See note 10 *supra* and accompanying text.

[17] Turnbow v. Commissioner, 368 U.S. 337, 343 (1961).

[18] "[A]n exchange of stock *and* cash—approximately 30 percentum in stock and 70 percentum in cash—for 'at least 80 per centum of the... stock of another corporation cannot be a 'reorganization' . . . and thus § 112(c) (1) cannot be applicable to petitioner's transaction. *That holding determines this case and is all we decide." Id.* at 344. (Emphasis added.)

[19] *Ibid.*

[20] One author views the issue raised by *Turnbow* as, "what circumstances are required to have a Section 368(a) (1) (B) reorganization." CCH FEDERAL TAXATION 829 (1962).

[21] INT. REV. CODE OF 1954, § 368(a) (1) (C) defines "reorganization" as: "(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in an exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;"

[22] See note 18 *supra.* Compare Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 198 (1942). "'Solely' leaves no leeway. Voting stock plus some other consideration does not meet the statutory [Type 'B'] requirement."

[23] The Senate Report on the 1954 Internal Revenue Act on § 356 specifically rejected the attempt by "section 306 of the House Bill of correlating 'boot' distributions made incident to a corporate reorganization and property distributions generally..." 3 *U.S.*

ential?[24] Until these questions are resolved it is safe to assume only that § 356(a) will apply solely to a Type *A reorganization*.[25] Section 368 (a) (1) (A) places no restriction upon the type of consideration which is to pass between the parties to the statutory merger or consolidation. Because of the wide variety of governing state statutes, no accurate generalization can be attempted regarding the availability of this method, although it is not without possible pitfalls.[26]

The caution which should follow *Turnbow* may not prove to be a substantial obstacle to planning in all cases, for the proposed transaction may still be planned and cast in a different form. Suggested alternatives may be: (1) The receipt of "solely stock" followed by its later sale.[27] (2) The acquiring corporation may, over the twelve months previous to the "solely stock" reorganization, acquire shares for cash.[28] (3) The transfer or shareholder may obtain a favorable employment contract or a covenant not to compete with the acquiring corporation.[29] (4) The prohibition against assuming liabilities should not prevent the acquiring corporation from either assuming a restricted stock option or substituting one under § 421(g).[30]

The decision by the Supreme Court in *Turnbow* should have the effect of making the tax practioner eliminate the use of "boot" in planning a Type *B* reorganization until the interplay between § 356(a) and § 368(a) (1) (B) is resolved. The alternative to "don't" is to attempt to plan the affairs of the taxpayer to utilize an alternative form for the transaction.

F. ROBERT DEBRUYN

Code Congressional and Administrative News 4906, 83rd Cong. 2d Sess. 1954. The Senate Report was adopted on this section. Further the Senate Report states: *"Receipt of additional consideration.*—Where a capitalization or other type of corporate reorganization occurs, a shareholder may receive money or other property, known as 'boot,' in addition to the stock or securities which may be received without the recognition of gain. Your committee's bill follows the House bill and *existing law* in not disqualifying the transaction as a whole as a tax-free exchange, but the 'boot' is subject to the tax." *Id.* at 4682. (Emphasis added.) This sweeping inclusion of present law and the rejection of the House change is certainly broad enough to incorporate the then existing Tax Court interpretation of 112(c) (1) and "boot." See Bonham v. Commissioner, 33 B.T.A. 1100 (1936).

This argument does have another side. What negative inferences arise from: (1) the change embodied in the type "C" reorganization under the 1954 Code and (2) the recommendations of an Advisory Group in 1958 to allow the receipt of up to 50% of the consideration in "boot." A bill embodying this latter recommendation was introduced but was not enacted. H.R. No. 4459, 86th Cong., 1st Sess., § 26 (1959). See, Note 73 HARV. L. REV. 1402 (1960) and Greene, *Proposed Definitional Changes in Reorganizations*, 14 TAX L. REV. 155, 160 (1959).

[24] In addition to the legislative history discussed in the preceding note, what will be the effect of the explicit cross sectional reference in § 354(a) (3) and the Regulations enacted under § 356, especially Treas. Reg. § 1.356-1(c) Example (1)?

[25] Assuming that *Turnbow* is a denial of its use in a "B" or "C" reorganization.

[26] See BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 362-63 (1959).

[27] See generally, McDonald & Willard, *Tax Free Acquisitions and Distribution*, N.Y.U. 14TH INSTITUTE ON FEDERAL TAXATION 859 (1956).

[28] A negative implication may arise from Treas. Reg. § 1.368-2 (c) ". . . an acquisition is permitted tax-free in a single transaction or in a series of transactions taking place over a relatively short period of time such as 12 months."

[29] McDonald and Willard, *supra* note 27 at 877.

[30] *Ibid.*