

## CASE NOTES

It is submitted that the dissent, led by Judge Clark, presents the preferable view. The Investment Advisers Act should not be given a poor relative standing, but should be construed with its predecessors *mutatis mutandis*.<sup>44</sup> The case reinstates all the former uncertainty as to the meaning of anti-fraud sections of securities legislation with an apologia of "everybody wins all around." Cited as the "worst feature" by the minority is that indulgence instead of opprobrium should be given to the scalping practice utilized by those with a low standard of business practice. Appropriate to this position is the oft-quoted passage from *Archer v. SEC*:<sup>45</sup>

The business of trading in securities is one in which opportunities for dishonesty are of constant recurrence and ever present. It engages acute, active minds, trained to quick apprehension, decision and action. The Congress has seen fit to regulate this business. Though such regulation must be done in strict subordination to Constitutional and lawful safeguards of individual rights, it is to be enforced notwithstanding the frauds to be suppressed may take on more subtle and involved forms than those in which dishonesty manifests itself in cruder and less specialized activities.

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**Taxation—Use of Cash in Type B Reorganization.—***Turnbow v. Commissioner*.<sup>1</sup>—Petitioner owned all of the 5,000 shares of outstanding stock in the International Dairy Supply Co., which shares he transferred in 1952 to Foremost Dairy Company. He received in exchange 82,375 shares (a minor percentage) of Foremost's common (voting) stock of a fair market value of \$1,235,625, plus a boot in the amount of \$3,000,000. The gain realized by the taxpayer on the exchange—i.e., stock and cash in excess of the basis of his own stock and expenses—was \$4,163,691.94.<sup>2</sup>

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lie awake nights endeavoring to conceive some devious and shadowy way of evading the law. It is more advisable to deal with each case as it arises."

<sup>44</sup> 3 Loss, op. cit. supra note 23, at 1515.

<sup>45</sup> 133 F.2d 795, 803 (8th Cir. 1943), cert. denied, 319 U.S. 767 (1943).

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<sup>1</sup> 368 U.S. 337 (1961).

<sup>2</sup> The following is the statutory complex from which the *Turnbow* and *Howard* issues arise.

Int. Rev. Code of 1939:

§ 112(b)(3) . . . 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.

§ 112(c)(1) . . . provides further, "if an exchange would have qualified under § 112(b)(3) but for the receipt of cash or property (boot) other than the permissible stock or securities, then the gain will not be recognized in full but will be recognized only in an amount not in excess of the boot."

§ 112(g)(1)(B) . . . by definition the term "reorganization" means "the acquisition by one corporation in exchange solely for all or a part of its voting stock, of at least 80 percentum of the stock of another corporation."

In petitioner's return for 1952, the gain was treated as recognizable only to the extent of the cash received. The Commissioner concluded that the whole of the gain was recognizable and assessed a deficiency accordingly. On a petition for redetermination, the Tax Court,<sup>3</sup> relying on an earlier decision in *Luther Bonham*<sup>4</sup> and on the opinion of the Seventh Circuit in *Howard v. Commissioner*,<sup>5</sup> held that the gain was recognizable only to the extent of the cash. The Ninth Circuit reversed, holding that the existence of boot prevented section 112(g)(1)(B) from applying.<sup>6</sup> HELD: That in the absence of a qualified reorganization within the meaning of the Code definition [112(g)(1)(B)], the boot provision of section 112(c)(1) providing for a limited recognition of gain on an exchange cannot apply.

The argument as advanced by the petitioner before the Ninth Circuit and the Supreme Court was based on the admission that there was no reorganization as defined in Section 112(g)(1)(B) of the 1939 Code, because the acquisition by Foremost was not in exchange solely for its voting stock—but was partly for such stock (thirty per cent), and partly for cash (seventy per cent).<sup>7</sup> Furthermore, it was not disputed that the transaction was not within the terms of section 112(b)(3) because the exchange was not between parties to a reorganization, pursuant to a plan of reorganization.<sup>8</sup>

Yet petitioner contended that section 112(c)(1) authorizes the indulging in assumptions, contrary to the actual facts, which would supply the missing elements necessary to make the exchange a reorganization as defined by section 112(g)(1)(B).

Drawing out the argument, "if it were not for the fact that the property received in the exchange consisted not only of voting stock (property permitted to be received [by 112(b)(3)]) but also of cash, the exchange would have been a 'reorganization' because the acquisition by Foremost would have been solely for its voting stock and, hence, it would have been of stock in a party to a reorganization in pursuance of a plan of reorganization [(112(b)(3))]."<sup>9</sup> Petitioner's whole contention rested on the premise that since his transaction would have been a reorganization had it not been for the cash received, then 112(c)(1) authorizes the assumption that the exchange was a reorganization as defined in section 112(g)(1)(B) and used in section 112(b)(3).

The Ninth Circuit<sup>10</sup> and the Supreme Court<sup>11</sup> denied the taxpayer's contention as being a passable negation of the true intention of Congress and as a means of avoiding a tax on what amounted to only a sale, the full gain from which is taxable under section 112(2). The Supreme Court ruled

<sup>3</sup> The Tax Court concluded "that *but for* the cash received by petitioner . . . the exchange would have met the 'solely' requirement of section 112(g)(1)(B) and fallen within section 112(b)(3). Therefore under section 112(c)(1) the gain to petitioner may not be recognized in an amount in excess of the cash received," 32 T.C. 646, 652 (1959).

<sup>4</sup> 33 B.T.A. 1100, 1104 (1936).

<sup>5</sup> 238 F.2d 943 (7th Cir. 1956).

<sup>6</sup> 286 F.2d 669 (9th Cir. 1960).

<sup>7</sup> *Supra* note 1, at 341.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Id.* at 342.

<sup>10</sup> *Supra* note 6, at 675.

<sup>11</sup> *Supra* note 1, at 343.

that a qualified and not a hypothetical reorganization must exist before the boot rule can come into play: *i.e.*, "That some part, at least, of the property exchanged must meet the particular description contained in the applicable section of the Code" [112(g)(1)(B)].<sup>12</sup>

In deciding as it did, the Supreme Court refused to accept the reasoning of the Seventh Circuit in *Howard* and earlier cases.<sup>13</sup> In *Howard*, the acquiring corporation exchanged its voting stock for eighty-one per cent of the shares acquired, but gave cash to a dissenting minority for the remaining nineteen per cent. The Tax Court ruled that the existence of the cash payment in the transaction precluded the finding of a type B reorganization since the "solely" requirement of the Code definition, section 112(g)(1)(B) was not met, *i.e.*, the voting stock was not given in exchange for every share of acquired stock.<sup>14</sup>

The Seventh Circuit agreed with the Tax Court's analysis up to this point, but it refused to accept the Commissioner's contention that "there must be a qualifying reorganization within the meaning of Section 112(g)(1)(B) before Section 112(c)(1) [the boot provision] could come into play." The Court of Appeals held that the boot provision was applicable since, *but for* the cash received, the transaction would have met the "solely" requirement of section 112(g)(1)(B) and, thereby falling within the scope of section 112(b)(3), would qualify as a tax exempt exchange.<sup>15</sup>

It would appear that what the Court of Appeals did was to use section 112(c)(1) to find in the transaction the elements of a reorganization as required by the Code and then to use section 112(c)(1) again to cause the transaction to come within the nontaxable provisions of 112(b)(3).

The Seventh Circuit concluded "[that] in determining when these so-called 'boot' provisions apply, Congress intended that the transaction is to be considered separate and apart from the boot received in determining whether it meets the non-recognition provisions. If the transaction, absent the 'other property or money' fulfills the requirements of Section 112(b)(3), then gain is to be recognized to the extent of the boot received."<sup>16</sup>

This dichotomy that existed between the Tax Court and the Court of Appeals in the *Howard* case concerning the proper interpretation of section 112(g)(1)(B) exemplifies the state of the law before *Turnbow*. The *Turnbow* decision then has clarified the law, to the extent at least, that the boot provision [112(c)(1)] operates only in a transaction which, independent of its [112(c)(1)] provisions, qualifies as a reorganization.

If the *Howard* case were to come up again today, the Supreme Court relying on *Turnbow* would reject in principle the argument of the peti-

<sup>12</sup> Id. at 343-44.

<sup>13</sup> First Seattle D.H. Nat. Bank v. Commissioner, 77 F.2d 45 (9th Cir. 1935); Elizabeth Bruce, 30 B.T.A. 80 (1934).

<sup>14</sup> 24 T.C. 792 (1955).

<sup>15</sup> Supra note 5, at 948.

<sup>16</sup> Ibid. The same reasoning—*i.e.*, "eliminate the cash and see what the transaction would then be" was also the basis of a number of prior decisions under section 112(c)(1) and its predecessors. Luther Bonham, 33 B.T.A. 1100, 1104 (1936); R. C. Love, 39 B.T.A. 172, 180 (1939); as well as the Tax Court in the instant case, supra note 3, at 650-52.

tioner, and yet the result of that case may well remain unchanged. That this may be so is due to the very narrow grounds upon which the *Turnbow* decision rested, *i.e.*, the problem of the boot [112(c)(1)] provision. Although it would be difficult to quarrel with as narrow an authoritative approach as was taken by the Court, yet, in doing so, the Court was able to avoid the more critical issue posed by *Howard*. In the *Howard* case eighty-one per cent of the stock acquired was acquired for voting stock, while the balance of nineteen per cent was acquired for cash.

Therefore, there remains still unanswered the issue whether the word "solely" in the statutory definition of a type B reorganization under the 1939 Code [112(g)(1)(B)] means that every share of stock acquired must be acquired for voting stock or only that the consideration allocable to at least eighty per cent of the stock acquired must be voting stock. The judicial weight of authority appears to favor the "solely for stock" concept.<sup>17</sup>

If the rule were that only a minimum of eighty per cent of the stock acquired had to be acquired for voting stock, then it would be possible, in a case such as *Howard*, for boot given over and above the eighty per cent, to be taxed under section 112(c)(1). There would in that case be an actual reorganization as defined in section 112(g)(1)(B) which would fall within section 112(c)(1) because, but for "the presence of the additional consideration," it would have qualified under section 112(b)(3) for tax free treatment.<sup>18</sup>

A basis for this line of argument may be found in the ambiguity of the Code section [112(g)(1)(B)]. The emphasis would be on the idea that the "solely for stock" concept is directly modified by the "minimum of eighty per cent requirement" to the extent that it requires that only a minimum of eighty per cent of the stock of the acquired corporation be acquired for voting stock.

If the type B reorganization definition were to admit of the possibility of such an interpretation, then the gain would be recognized only to the extent of the boot received and not in its entirety as it was in two previously noted cases.<sup>19</sup> And in a situation as in the *Howard* case where eighty-one per cent of the stock acquired was acquired for voting stock, the balance having been paid for in cash, there would be a qualified type B reorganization with the gain to be recognized only to the extent of the boot received.

By specifically not ruling on the issue of the proper meaning of a type B reorganization, the Court has let stand the present authority all on one side, that supporting the view that only qualified stock may be passed as consideration for the acquired stock in a type B reorganization.

Yet, by its silence, the Court has left the door open for future limiting

<sup>17</sup> *Commissioner v. Air Reduction Co.*, 130 F.2d 145 (2d Cir. 1942). The Second Circuit denied petitioner's contention that the transaction involved was a non taxable reorganization, by ruling that § 112(g)(1)(B) contemplates only situations where the exchange is made *solely* for voting stock. Here over 17% of the stock acquired was purchased for cash. Also, for a similar holding, see *Howard v. Commissioner*, *supra* note 14.

<sup>18</sup> For a full discussion of cases in support of the "minimum-of-80 percent for stock approach" see 1 Rhoener on Federal Taxation, No. 3 (September 9, 1955).

<sup>19</sup> *Supra* note 17.

decisions and, perhaps, has cast some doubt on the significance of such authority. It will possibly take a decision by a Court of Appeals favoring the "minimum of eighty per cent" rule, before the issue will come before the Supreme Court again.

It is to be further noted that these problems of interpretation which arose under the ambiguity of the 1939 Code, would appear to be averted by the 1954 provision. The modifications in language in the 1954 Code appear to have greatly clarified congressional intent. A reading of section 368(a)(B)<sup>20</sup> and a comparison with the comparable 1939 provision [section 112(g)(1)(B)] point up a change of sentence structure which perhaps leaves little doubt that the solely for stock provision relates directly to the purchase of each share of stock of the acquired company, unmodified by any minimum percentage.<sup>21</sup>

BRIAN J. MORAN

**Torts—Extension of MacPherson Doctrine to Contractors—Decline of Requirement of Privity.**—*Cosgriff Neon Co., Inc. v. Mattheus*.<sup>1</sup>—A conditional seller pursuant to a contract with a shopping center erected an electric neon sign on Mattheus' brick pylon which sign was totally destroyed one day later when the pylon collapsed due to faulty construction. The conditional seller intervened in a negligence suit by the owner against the contractor and sought to recover the value of the sign, joining both the owner of the brick pylon and the contractor. The lower court denied the intervenor relief because of his lack of privity with both the plaintiff and the defendant, stating that his action was against the shopping center on the conditional sales contract. In reversing the lower court, the Supreme Court of Nevada HELD: The contractor, who negligently constructed the brick pylon, was liable in tort to the conditional seller of the sign, though there was no contractual privity between the contractor and the seller, and though the owner of the brick pylon had accepted it from the contractor prior to its collapse. The owner of the brick pylon was not liable to the seller, where the defect in the brick pylon was latent so that the owner could not have discovered the defect on a reasonable inspection.

Where the buyer is in possession of the subject of the sale and in default on his payments under the conditional sales contract, as was the case in

<sup>20</sup> Internal Revenue Code of 1954, § 368:

(a) Reorganization

(1) Means . . . .

(B) The acquisition by one corporation in exchange solely for all or a part of its voting stock, of stock in another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before acquisition).

<sup>21</sup> In the 1954 Code definition, the removal of the phrase "at least 80 percentum" and the substitution of the word "control" leaves little doubt that the word "solely" refers to every share of stock acquired. Its removal would appear to preclude any cash from being exchanged in a type B reorganization.

<sup>1</sup> 371 P.2d 819 (Nev. 1962).