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The Continuity of Interest Test in Reorganizations — a Blessing or a Curse

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THE HISTORY of the so-called reorganization provisions¹ of the Internal Revenue Code and of their interpretation has not been an altogether happy one. Since these provisions were deliberately intended to prescribe a precise statutory formula which business could read and follow and thereby predetermine the tax consequences which would follow from thoughtfully evolved corporate readjustments, certainty in meaning was of the essence. Through an unfortunate oversight, however, from one of the self-sufficient portions of these provisions was omitted the statement of a requirement which was needed to make it fit sensibly into the statutory scheme. As a result the courts were simply unable to believe that that particular provision meant what it literally said, and in order to close the loophole that omission opened they erected a barrier in the form of the continuity of interest test. In essence, this test meant that before a transaction which literally satisfied this mistakenly drafted portion of the statutes could be recognized as a reorganization, the court must find that the interests which had a stake in the enterprise before the transaction continued to have one after it.

The placing of a judicially created gloss on statutory language otherwise clear not infrequently destroys certainty. Sometimes that is the object of the gloss and the existence of uncertainty is deemed good,² but this was not such a case. So Congress repaired the offending

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¹ By which is meant those provisions of the Internal Revenue Code defining reorganizations, prescribing their tax effect on the constituent corporations, and also their tax effect on the shareholders and security-holders in the constituent corporations.

² Perhaps *Gregory v. Helvering* (1935) 293 U.S. 465, is in this class. The problems resulting from this case are beyond the scope of this article.

portion of the statute and repaired it well. The continuity of interest test thus had completed the task for which it was created, *i.e.*, it had held the fort until Congress could come to the rescue. But the test was not static and in later applications to the earlier, faulty statute it expanded far beyond its original limits. It also seeped over into companion problems. Its present dimensions are not predictable: recent applications of it³ give it an extent and form wholly unforeseeable eleven years ago when Congress repaired the weakness which had caused the test to be enunciated. The result is that today, over twenty-four years after these provisions were enacted to provide certainty, there is sufficient uncertainty over their meaning to make it virtually unpredictable in reorganizations involving debt obligations. The continuity of interest test could fairly have been described as a blessing when it first appeared. Today it can equally fairly be called a curse.⁴ The points which this article will endeavor to make are: (1) that certainty in the meaning of these provisions is vital if the congressional purpose is to be effectuated; (2) that certainty can be achieved without sacrificing any of the merits of the continuity of interest test; (3) that if that test is applied properly, it points the way out of the present confusion; and (4) that the task of ending the present uncertainty is the Supreme Court's task.

The history of the birth and development of these provisions reveals the emphasis with which Congress regarded the need for certainty in this field and affords at least a partial premise for the view that Congress can rightfully feel aggrieved that the courts have not cooperated more fully toward the attainment of this certainty. This history likewise does much to suggest the proper way out of the present uncertainty by showing the general purpose and intentment of these provisions.

After a preliminary flurry in section 202(b) of the Revenue Act of 1918 and the regulations interpreting that provision,⁵ the definition of reorganization and the more important related provisions acquired a form in section 202(c) of the Revenue Act of 1921 in which their

³ In *Roebeling v. Commissioner* (C.C.A. 3d, 1944) 143 F. (2d) 810, *cert. den.* (1944) 313 U.S. 773; *Neville Coke & Chemical Co. v. Commissioner* (C.C.A. 3d, 1945) 148 F. (2d) 599, *cert. den.* Oct. 8, 1945, No. 149, October Term, 1945; and *Bedford v. Commissioner* (C.C.A. 2d, 1945) 150 F. (2d) 341. These decisions are discussed at length hereinafter.

⁴ Somewhat this same point of view is expressed in Griswold, "*Securities*" and "*Continuity of Interest*," (1945) 58 HARV. L. REV. 705.

⁵ Reg. 45 (1920) Articles 1567, 1568.

ancestral relation to the present provisions is readily recognizable. For present purposes the pertinent provision was section 202(c)(2), which stated:

“... no gain or loss shall be recognized

“(2) When in the reorganization of one or more corporations a person receives in place of any stock or securities owned by him, stock or securities in a corporation a party to or resulting from such reorganization. The word ‘reorganization’, as used in this paragraph, includes a merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation), recapitalization, or mere change in identity, form, or place of organization of a corporation, (however effected);”

The genesis of section 112(b)(3) and 112(g)(1) of the Code may be clearly seen here, and by regulation⁶ the Treasury construed this provision so as to encompass present section 112(b)(4) as well.

The addition of this provision and related ones was urged in 1921 by the Senate Committee on Finance as a means of eliminating “grave uncertainty” and “many technical constructions which are economically unsound,” as well as to “permit business to go forward with the readjustments required by existing conditions.”⁷ Notwithstanding the adoption of the 1921 provisions, however, uncertainty continued to exist, partly because not all the consequences of postponement of recognition of gain or loss had been fully appreciated and provided for in 1921, and partly because of the unworkability of the 1921 provision⁸ not recognizing gain on exchanges unless the property received had a “readily realizable market value.” In 1924 Congress eliminated the latter provision and also amended the non-recognition provisions into approximately their present form.⁹ The purpose in these changes was expressed by the Committee on Ways and Means as follows:¹⁰

⁶ Reg. 62 (1922) Article 1566(b).

⁷ SEN. REP. NO. 275, 67th Cong., 1st Sess. (1921); 1939-1 CUM. BUL. (Pt. 2), 187, 189.

⁸ REV. ACT OF 1921, §202(c), 42 STAT. (1921) 227, 230.

⁹ Sections 112(b) (1) to (5), I. R. C., inclusive, are exactly the same as sections 203(b) (1) to (4) of the 1924 Act, [43 STAT. (1924) 253, 256], inclusive, except for the split-up of subd. (1) of the latter into subd. (1) and (2) of the former, and the Hendler addition to subd. (5) of the former. The definition of “reorganization” in section 203(h) (1) of the 1924 Act was continued unchanged until it was rewritten in part more precisely in the 1934 Act. As rewritten it is now in section 112(g) (1), I.R.C., with the Hendler addition to clause C which made its appearance in 1939.

¹⁰ H. REP. NO. 179, 68th Cong., 1st Sess. (1924); 1939-1 CUM. BUL. (Pt. 2), 241, 251.

"It appears best to provide generally that gain or loss is recognized from all exchanges and then except specifically and in definite terms those cases of exchange in which it is not desired to tax the gain or allow the loss. This results in definiteness and accuracy and enables a taxpayer to determine prior to the consummation of a given transaction the tax liability that will result therefrom."

It is thus a known fact that predictability and certainty were important objectives sought by Congress in the enactment of the reorganization provisions. They were, of course, subsidiary objectives, the primary objective being to avoid hampering business and financial readjustments by imposing a tax on paper profits which were for practical purposes not yet realized.¹¹ The attainment of this objective, however, necessarily required the existence of predictability and certainty in the law, for obvious reasons.

The importance which Congress attached to the elements of predictability and certainty in this field is further evidenced by the background from which the 1921 provisions sprang. The Revenue Bill of 1921, containing the reorganization and tax-free exchange provisions finally enacted, was reported by the Senate Committee on Finance on September 26, 1921.¹² None of the Supreme Court decisions holding that constitutionally recognizable gain was realized in reorganizations had at that time even been argued and submitted in that court. The first two of those decisions¹³ were not decided until nearly two months later. The district court decision of Judge L. Hand holding the gain taxable in one of them¹⁴ had been rendered less than two months before. If the Court of Claims should have proved correct in its unani-

The Senate Committee on Finance made an identical statement of purpose [SEN. REP. NO. 398, 68th Cong., 1st Sess. (1924); 1939-1 CUM. BUL. (Pt. 2), 266, 275].

¹¹ H. REP. NO. 179, 68th Cong., 1st Sess. (1924); 1939-1 CUM. BUL. (Pt. 2), 251; SEN. REP. NO. 398, 68th Cong., 1st Sess.; (1939-1 CUM. BUL. (Pt. 2), 276. It has been stated that another objective was to prevent taxpayers' taking insubstantial paper losses. BAAR AND MORRIS, HIDDEN TAXES IN CORPORATE REORGANIZATIONS (1935) 5; Prevention of Tax Avoidance, Report of Ways and Means Subcommittee, Appendix D (H. REP. DEC. 4, 1933, 73d Cong., 2d Sess.); SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938) 332, 334.

¹² The bill went to conference and the conference bill was signed and became law on November 23, 1921.

¹³ *United States v. Phellis*, 257 U.S. 156, and *Rockefeller v. United States*, 257 U.S. 176, both decided November 21, 1921. The last of this series of cases, *Marr v. United States*, 268 U.S. 536, was not decided until June 1, 1925.

¹⁴ *New York Trust Co. v. Edwards* (D.C.S.D.N.Y., 1921) 274 Fed. 952, *aff'd. sub nom. Rockefeller v. United States* (1921) 257 U.S. 176.

mous decision for the taxpayers in the other case,¹⁵ some or all of the proposed provisions would have been unnecessary. But the issue was then in hot dispute and the final outcome was uncertain.¹⁶ The action of Congress in not awaiting the outcome of the litigation but instead in acting to settle the issue prospectively regardless of the possibility that the eventual court decisions might make all or part of this legislation unnecessary, is strongly indicative of a congressional view that certainty must be achieved even at the risk of eventual superfluity.

This emphasis on predictability and certainty is further apparent in the effort at completeness and precision evident in the non-recognition of gain provisions and the accompanying basis provisions as they emerged in the 1924 Act. Theretofore the revenue laws had tended to be expressed in more general terms than is customary today. These provisions were probably the most detailed and precise statutes which had been evolved up to that time and compare favorably in detail and attempted precision with the non-recognition of gain provisions in effect today, which are still considered fairly detailed and complex. Certainly the effort to be complete and precise made in 1924 was, in relation to the custom of the times, herculean and denoted a serious and genuine preoccupation with predictability and certainty.

For several years after 1924 nothing seriously wrong developed with the draftsmanship of these provisions and, within fairly broad limits, the desired predictability and certainty appeared to have been attained. Unfortunately, however, Congress had made a blunder of draftsmanship originating in the 1921 Act which potentially was of the utmost seriousness. This blunder lay primarily in the language of the parenthetical clause defining reorganization¹⁷ to include:

¹⁵ *Phellis v. United States* (1921) 56 Ct. Cl. 157.

¹⁶ The decisions when they came were not always unanimous. In the *Phellis* and *Rockefeller* cases, *supra* note 13, and *Weiss v. Stearn* (1924) 265 U.S. 242, two justices dissented. In *Marr v. United States*, *supra* note 13, the number of dissenters rose to four.

¹⁷ This blunder made its appearance in the Senate bill in 1921. The House bill defined reorganization to include "merger, consolidation (however effected), . . ." The Senate committee bill changed it to read "merger or consolidation (including the acquisition by one corporation of substantially all the stock or of substantially all the properties of another corporation), . . ." A Senate floor amendment changed it into its final form. The considerable debate on the floor indicates the purpose of the change was to make certain that an acquisition by one corporation in exchange for its own stock of the stock or properties of another corporation would be regarded as a merger even though there was a substantial dissenting minority among the shareholders of the acquired corporation. No awareness was indicated that as phrased the provision did not specify the type of consideration the acquiring corporation must give. 61 CONG. REC. 6549-6568. The

"merger or consolidation (including the acquisition by one corporation of at least a majority of the voting stock and at least a majority of the total number of shares of all other classes of stock of another corporation, or of substantially all the properties of another corporation);"

Under the literal meaning of this parenthetical clause a purchase by one corporation of a majority of shares of all classes of stock of another corporation or of substantially all the properties of another corporation was a "reorganization" even if it was for cash. If it was for cash, however, none of the benefits usually attendant on reorganizations, such as non-recognition of gain and carry-over of basis, would follow because a cash transaction would not fit other provisions on which the attachment of such benefits would depend. But as between purchaser and seller it often matters not if instead of being cash the consideration is short-term notes of the purchaser secured by the property sold. Such a sale would literally fit the language of the parenthetical clause and, as the short-term notes would seem to be "securities" in the most literal sense, the provisions on which the attendant benefits of non-recognition of gain and carry-over of basis depended likewise would be literally satisfied. So in due course sales occurred by corporations of substantially all their assets to other corporations for the short-term notes of the latter, and the question was raised whether the gain was entitled to non-recognition under the tax statutes. The taxpayers' contention in favor of non-recognition had to establish three points: one, that the transaction was a "reorganization" within the parenthetical clause; two, that the short-term notes were "securities"; and three, that there was an exchange of property for these securities. If the statute was to be applied literally, clearly the transaction was a "reorganization" and there was an exchange, but since the statute did not define "securities" there may have been room for debate on the second point where the notes were extremely short-term. Little if any doubt could be felt that the transaction was not intended to be within the favored class of "reorganizations" since it was in substance a mere sale for cash, but refusal to apply the definition literally would impair in substantial degree the predictability and certainty intended by the adoption of these detailed provisions.

The courts reacted to the problem characteristically: they cracked down on the cases before them and denied them the benefits of the tax-

free reorganization statutes. The first such decision was *Pinellas Ice & Cold Storage Co. v. Commissioner*.¹⁸ The sale involved was for cash plus notes secured by a mortgage, the notes being payable within five months. The Board of Tax Appeals agreed that notes generally could be regarded as "securities" but held that the statute was inapplicable unless the property was exchanged for securities and here there was no exchange but a sale. The Board also declared that purchase money obligations are not "securities" within the meaning of the statute. On appeal this decision was affirmed by the fifth circuit¹⁹ on a different ground, one which had some support in the legislative history²⁰ but which was not altogether in accord with the literal sense of the statute. The court held that the parenthetical clause was intended to be applicable only to "mergers" and "consolidations" as those terms are commonly understood. This interpretation amounted to a virtual repeal of the parenthetical clause, and was eventually rejected by the Supreme Court.²¹ In the meantime, the similar case of *Cortland Specialty Co. v. Commissioner*,²² had arisen in which the purchase money notes were payable within fourteen months of the sale but were unsecured. This time the Board held that the transaction was not a "reorganization," because it did not satisfy the definition of "reorganization" found in Morawetz on Private Corporations, Fletcher's Cyclopaedia Corporations or Thompson on Corporations, and was not a "merger" or "consolidation" as those terms are usually understood. Since Congress had defined "reorganization" in some detail and that definition was controlling, the Board's new approach was subject to some question, and was not adopted on review. The decision was affirmed, however,²³ on the dual grounds that the transaction was not a "reorganization" and that the short-term notes were not "securities." The court held that the purpose behind the provisions compelled the confinement of their application to cases where the transferor retained an appreciable interest in the assets after the transfer.²⁴ Here then

¹⁸ (1930) 21 B.T.A. 425.

¹⁹ (C.C.A. 5th, 1932) 57 F. (2d) 188.

²⁰ *Supra* note 17.

²¹ (1933) 287 U.S. 462.

²² 22 B.T.A. 808.

²³ *Cortland Specialty Co. v. Commissioner* (C.C.A. 2d, 1932) 60 F. (2d) 937, *cert. den.* (1933) 288 U.S. 599.

²⁴ In an earlier decision [*Corbett v. Burnet* (App.D.C., 1931) 50 F. (2d) 492] a court had held the transfer of property for cash, short-term notes and serial bonds due within four years was not a reorganization but a sale.

we have substantially the same case decided the same way four times on a total of six different grounds, not all mutually consistent.

The Supreme Court affirmed the decisions below in the *Pinellas* case.²⁵ It adopted both grounds advanced by the second circuit in the *Cortland Specialty* case and specifically rejected the ground relied on below by the fifth circuit. The entire emphasis of the opinion is on the short-term character of the notes. The major premise of the opinion is that gain would have been recognized if the sale had been for cash, and the minor premise is that the short-term notes were essentially the equivalent of cash. From these foundations two conclusions were reached: one, that the short-term notes, being essentially the same as cash, were not "securities" within the meaning of the statute; two, the transaction was not a "reorganization" within the intentment of the parenthetical clause because the transferor did not retain a continuing interest in the assets "more definite than that incident to ownership of . . . short-term purchase-money notes."

At this juncture Congress took over the stage. A sub-committee of the House Ways and Means Committee had been studying the tax-free exchange provisions, and on December 4, 1933 it issued a report finding that these provisions had become avenues of tax avoidance and were undesirably complicated and recommending their repeal.²⁶ The Treasury, however, pointed out that rather than increase the revenue such repeal would, through the allowance of otherwise non-recognizable losses, probably result in a net loss of revenue.²⁷ The result of all this attention was that several changes were made in the existing provisions, including the repeal of the parenthetical clause and the re-writing of the definition of "reorganization" to limit it somewhat and to make it more precise. The various subcommittee and committee reports²⁸ show that Congress was well aware of the imperfections of the old parenthetical clause and further show that the primary object of the more precise redefinition of "reorganization" was to eliminate those imperfections while at the same time making possible the attainment of the original objectives. The House Committee, in reporting its proposed amendments, noted that "astute lawyers frequently attempted . . . to take advantage of these provisions by arranging in the

²⁵ *Pinellas Ice & Cold Storage Co. v. Commissioner* (1933) 287 U.S. 462.

²⁶ Prevention of Tax Avoidance, Preliminary Report of a Subcommittee of the Committee on Ways and Means, 73d Cong., 2d Sess., (1934) 8, 37; SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS (1938) 332.

²⁷ H. REP. 704, 73rd Cong., 2d Sess., (1934) 12; 1939-1 CUM. BUL. (Pt. 2), 554, 563.

²⁸ *Supra* notes 26 and 27; *infra* notes 29 and 30.

technical form of a reorganization, . . . what were really sales," observed that the Government had defeated these attempts in court, and then explained its proposal as follows:²⁹

"In the second place, the definition of a reorganization has been restricted so that the definition will conform more closely to the general requirements of corporation law, and will limit reorganizations to (1) statutory mergers and consolidations; (2) transfers to a controlled corporation, . . . ; and (3) changes in the capital structure or form of organization.

"By these limitations the committee believes that it has removed the danger that taxable sales can be cast into the form of a reorganization, while at the same time, legitimate reorganizations, required in order to strengthen the financial condition of the corporation, will be permitted. Furthermore, the retention of the other reorganization provisions will prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments.

". . . many corporations have defaulted upon the dividends on their cumulative preferred stock, or upon the interest on their bonds. These corporations, in order to obtain necessary credit from the banks, are arranging with their preferred stockholders to accept new common stock, and with their bondholders to accept noncumulative preferred stock in place of preferred stock or bonds now held. If the reorganization provision were omitted from the bill, these stockholders and bondholders could take large losses, although they still retain an interest in the corporation."

It is plain that the Committee was aware of the *Pinellas* decision, approved it and wished to cast it into statutory form. It is also plain that the Committee believed that a change of a bondholder's interest into a proprietary interest was a tax-free exchange of securities for stock in a reorganization. The significance of these facts, if not immediately apparent, will be subsequently developed.

In a curious parallel to the legislative chronology of the 1921 provisions, the Senate Committee on Finance agreed in principle with the House proposals but felt that many corporate readjustments which were not technical mergers or consolidations under state law were sufficiently close to them in substance to merit the same treatment. Consequently, the Senate Committee recommended³⁰ the addition of clause B,³¹ which was the counterpart and genealogical descendent of

²⁹ H. REP. 704, 73d Cong., 2d Sess. (1934) ; 1939-1 CUM. BUL. (Pt. 2), 254, 564.

³⁰ SEN. REP. 558, 73d Cong., 2d Sess. (1934) ; 1939-1 CUM. BUL. (Pt. 2), 586, 598.

³¹ REV. ACT OF 1934, §112(g) (1) (B), 48 STAT. (1934) 680, 705.

the old parenthetical clause. This time, however, the imperfection was gone and the consideration required on both sides of the exchange was specifically stated. The Senate Committee proposal passed, was adopted in conference,³² and is in the statute today.³³

The new provisions were only prospective in application, so cases continued to arise under the old provisions. A series of them reached the Supreme Court and were decided by it in the subsequent year. In the first of these, *Helvering v. Minnesota Tea Co.*,³⁴ a corporation sold its assets to another corporation for \$426,842 in cash and 18,000 shares of common stock having a market value of about \$540,000.³⁵ This transaction was held to be a reorganization on a literal interpretation of the old parenthetical clause, and the court refused to read into the definition several restrictive glosses for which the Government argued.³⁶ Since the consideration for the transfer was not solely voting stock of the transferee and neither the transferor nor its shareholders controlled the transferee after the transfer, this transaction would not qualify as a reorganization under the present precise and more restrictive definition, unless it could qualify under the governing state law as a merger, which is unlikely.

The second case in this series was *John A. Nelson Co. v. Helvering*,³⁷ in which the lower court had held there was not a reorganization but a sale. The transaction involved was the acquisition by one corporation for \$2,000,000 in cash and all its non-voting preferred stock of substantially all the properties of another corporation. The latter corporation promptly paid off its own preferred shareholders in cash and distributed the newly acquired stock to its other shareholders. The Supreme Court held that this was a reorganization under the old parenthetical clause because the statute was literally satisfied and the acquisition of non-voting preferred stock gave the transferor a sufficient continuing interest to satisfy the gloss placed on the statute in the *Pinellas* case. This transaction would not, however, be a reorgan-

³² H. REP. 1385, 73d Cong., 2d Sess. (1934) ; 1939-1 CUM. BUL. (Pt. 2), 627, 632.

³³ I.R.C. §112(g) (1) (B) and (C).

³⁴ (1935) 296 U.S. 378.

³⁵ This figure is constructed from the findings of the Board in (1933) 28 B.T.A. 591, which also disclose that the total outstanding shares of the transferee corporation numbered 239,726.

³⁶ A companion case, *G. & K. Mfg. Co. v. Helvering* (1935) 296 U.S. 389, was substantially identical.

³⁷ (1935) 296 U.S. 374.

ization under the present statute for the same reason the one in the *Minnesota Tea* case would not be.

The final important case in this series was *Helvering v. Watts*,³⁸ in which Vanadium Corporation acquired all the stock of Ferro Alloys for some of its own common stock and \$1,161,184 of bonds of Ferro Alloys which Vanadium caused to be issued by Ferro Alloys after acquiring control of the latter and which Vanadium guaranteed. This transaction was held to be a reorganization within the old parenthetical clause. The Commissioner also argued that even if the transaction was a reorganization, gain was recognized to the extent of the bonds because the bonds were received in exchange for stock, this exchange resulted in a substantial change of position and therefore the bonds were not "securities" within the meaning of what is now Internal Revenue Code section 112(b)(3). This contention was also rejected and the bonds were held to be "securities . . . and cannot be regarded as cash, as were the short-term notes referred to in *Pinellas*"³⁹

A second and closer inspection of these bonds is justified.⁴⁰ When the contract for the transfer of the Ferro Alloys stock to Vanadium was made these bonds were not in existence. This contract required Vanadium to cause Ferro Alloys to issue them and to secure them by a mortgage on its property, and also required Vanadium to guarantee them. Once issued the bonds were to be transferred to the old shareholders of Ferro Alloys as additional consideration for their transfer to Vanadium of their stock in Ferro Alloys. The bonds were thus purchase money bonds secured by a mortgage on the property transferred. Their dates of maturity ran from two months to seven years, one month from date of issuance, and the obligor could call them all on ninety days' notice. These bonds were held to be "securities," and not essentially equivalent to cash as were the short-term notes in the *Pinellas* case. And it should be recalled that the statute using the term "securities," which was construed in the *Watts* case, remains unchanged today.

The continuity of interest doctrine now appeared to be fully developed, there remaining for decision only the detail as to where the line lay between the short-term notes which were to be treated the same as cash, and the more long-lived types of obligations which could be recognized as "securities." As was to be expected, being without legisla-

³⁸ (1935) 296 U.S. 387.

³⁹ *Ibid.* at 389.

⁴⁰ See *John J. Watts v. Commissioner* (1933) 28 B.T.A. 1056, where the facts are

tive mandate on this point the courts were not finding the line of division to be sharply visible. They were, however, in apparent agreement that the question was the same whether the issue was the meaning of "securities" or was the meaning of the old parenthetical clause in the definition of "reorganization"; namely, was the obligation long-term so that the retained interest continued for an appreciable period, or was it short-term so that it was essentially equivalent to cash. This question was one where the answer on either extreme was easy but where there was no natural line of demarcation between the approaches from the two extremes: thus a decision to draw the line at, for example, two and one-half years would be simply an arbitrary selection of a point of time, justified in relation to other alternative points of time only by the desperate necessity of drawing the line somewhere. In an ideal world such a decision is one courts would not be asked to make; the legislature is the forum for such a decision.⁴¹ Perhaps the Supreme Court felt this way about it too; at least this seems to offer the only possible explanation for the next step it took in this story.

This step was taken in *LeTulle v. Scofield*,⁴² where in 1931 X Corporation transferred all its assets to Y Corporation for \$50,000 cash and \$750,000 in bonds of the Y Corporation, payable serially over a period ranging from fourteen months to thirteen years from the date of the transfer. X Corporation distributed the cash and bonds to its shareholders and dissolved. The bonds were secured by a mortgage on the assets transferred and were callable at a discount during the period between two months and eleven months from the date of the transfer.⁴³ The circuit court of appeals held that receipt of the bonds was a tax-free exchange of property for securities pursuant to a reorganization, but rendered decision against the taxpayer on another ground. The taxpayer petitioned for and obtained certiorari on the ground that the circuit court should not have reversed the district court on a point not argued or briefed before it.⁴⁴ The Supreme Court then entertained the additional argument that the transaction was not a tax-free exchange at all. To establish that it was, the taxpayer had to show (1) that the transaction was a "reorganization" within the old parenthetical clause, and (2) that the bonds were "securities" within

set forth more fully than in the Supreme Court's opinion.

⁴¹ Cf. *Carmichael v. Southern Coal Co.* (1937) 301 U.S. 495, 510.

⁴² (1940) 308 U.S. 415.

⁴³ See *Scofield v. LeTulle* (C.C.A. 5th, 1939) 103 F. (2d) 20, 21.

⁴⁴ (1940) 308 U.S. 415, 416.

sections 112(b) (4) and 112(d) (1) of the Revenue Act of 1928.⁴⁵ Since the bonds were substantially identical to those held to be "securities" in the *Watts* case,⁴⁶ except that they expired serially over a longer term and contained a more restrictive call provision, they were "securities" unless the *Watts* case was to be overruled. The court did not overrule the *Watts* case; instead it cited it approvingly and briefly pointed out on its authority that where corporate property is exchanged for stocks and bonds "the total consideration received is exempt from tax under section 112(b)(4) and 112 (g)." Since this could not be correct unless the *Watts* bonds were "securities," it is evident the court did not intend a departure from its *Watts* decision. The court did, however, hold that the transaction was not a reorganization within the old parenthetical clause. It stated that if the only interest a transferor retained was a creditor's interest, even a long-term one secured by a mortgage on the property transferred, it was the wrong kind of interest to satisfy the continuity of interest test under the parenthetical clause. The court cited *Pinellas Ice etc. Co. v. Commissioner*⁴⁷ for the proposition that the parenthetical clause was not to be read literally, and then said that the term of the obligations, on which so much weight was placed in the *Pinellas* case, is not material in construing the parenthetical clause because a continuing proprietary interest was needed.

The *LeTulle* decision was rendered in early 1940, nearly six years after the elimination of the parenthetical clause and nineteen years after its original enactment. In view of the original desire for certainty and predictability which prompted the enactment of the tax-free exchange provisions, the significance of the blunder which the draftsmanship of the parenthetical clause constituted begins to appear. One additional group of cases involving the old parenthetical clause was, however, yet to be decided. The Bureau had from the outset of the reorganization provisions taken the position that bondholders' foreclosures followed by the transfer of the properties to a new corporation in which the former bondholders took all the stock were reorganizations on which no gain or loss was recognized.⁴⁸ This position had been sustained in court.⁴⁹ Soon after the *LeTulle* decision the Govern-

⁴⁵ 45 STAT. (1928) 791, 816.

⁴⁶ *Helvering v. Watts*, *supra* note 38.

⁴⁷ *Supra* note 25.

⁴⁸ I.T. 2071, III-2 (1924) CUM. BUL. 34; I.T. 2258, V-1 (1926) CUM. BUL. 10.

⁴⁹ *Commissioner v. Kitselman* (C.C.A. 7th, 1937) 89 F. (2d) 458, *cert. den.* (1937)

ment began to argue the other way, relying on the *LeTulle* case, and this problem reached the Supreme Court. But that court, in *Helvering v. Alabama Asphaltic Limestone Co.*,⁵⁰ refused to give a rigidly logical application to the *LeTulle* case and held a creditors' reorganization was a "reorganization" within the old parenthetical clause. The creditors involved were not bondholders but were holders of unsecured notes taken for advances and small creditors, and in exchange for their obligations they acquired all the stock of the new corporation.⁵¹ The question involved in the case was not, however, whether there was a tax-free exchange of "securities" for stock but whether the basis of the property in the hands of the old corporation carried over to the new corporation, and this question depended simply on whether the transaction constituted a reorganization within the old parenthetical clause. The statutory requirements were literally satisfied and this time the court found nothing in the continuity of interest gloss to prevent the statute's being given literal effect. It stated that the creditors had become the real proprietors of the business when the debts were defaulted and the reorganization merely continued this proprietary interest.⁵²

In a similar case decided the same day under the new definition of "reorganization" adopted in 1934, the issue was the same but the contrary result was reached. In this case, *Helvering v. Southwest Consolidated Corporation*,⁵³ a bondholders' foreclosure occurred, followed by the formation of a new corporation, the acquisition by it of the property of the old corporation, and the issuance of the stock of the new corporation to the creditors⁵⁴ of the old. The unsecured creditors were also given Class A stock purchase warrants, and Class B warrants were issued to the stockholders of the old corporation. The court stated that this transaction would have been a "reorganization" under the old statutes but the continuity of interest test was made "much

302 U.S. 709; *Commissioner v. Newberry Lumber etc. Co.* (C.C.A. 6th, 1938) 94 F. (2d) 447.

⁵⁰ (1942) 315 U.S. 179.

⁵¹ The facts are set forth in detail in *Alabama Asphaltic Limestone Co. v. Commissioner* (1940) 41 B.T.A. 324.

⁵² In *Helvering v. Cement Investors* (1924) 316 U.S. 527, the court later used the same technique in letting the creditors use section 112(b)(5) to avoid tax.

⁵³ (1942) 315 U.S. 194.

⁵⁴ Some of the creditors were non-assenting and received cash. From the statement of the facts in *Commissioner v. Southwest Consol. Corp.* (C.C.A. 5th, 1941) 119 F. (2d) 561, 563, it appears that the creditors included bondholders, holders of unsecured notes, and general creditors.

stricter" by the language of the new definition so that this type of transaction could no longer qualify.⁵⁵

Congress shortly became dissatisfied with the distinction drawn between the old and the new statutes,⁵⁶ and enacted new provisions designed to eliminate the distinction, in favor of what it conceived to be the result obtaining under the pre-1934 statute as interpreted in the *Alabama Asphaltic* case. These provisions were enacted in the Revenue Act of 1943 and now are found in Internal Revenue Code sections 112(b)(10) and 112(l). As initiated by the Senate Committee on Finance, these provisions contained subdivisions substantially like the present section 112(b)(10) except for the provision in the latter excepting railroad corporations, but contained no provisions postponing recognition of gain or loss to the shareholders and security-holders.⁵⁷ Instead the Senate Committee proposal specifically provided that as a general rule gain or loss would be recognized on "The acquisition . . . of stock or securities in a corporation organized or made use of to effectuate a plan of reorganization approved by the court . . . and the relinquishment or extinguishment in connection therewith of stock, securities or other obligations of the corporation whose property is transferred"⁵⁸ The bill went to conference in that form, and in conference was rewritten to substitute the provisions which became the law. The conference report⁵⁹ states that the purpose of these provisions is "to resolve some of the doubts and uncertainties which result from existing law as construed in the Supreme Court decisions. . . . the amendments relative to the recognition of gain or loss of the reorganizing corporation and the basis of its property in the hands of the successor corporation are made retroactive as if they were a part of the law back through the Revenue Act of 1934. . . . For reasons of administration, however, it is provided that such amendments shall not operate to affect the tax liability for any taxable year beginning prior to January 1, 1940.

⁵⁵ However, a simpler but otherwise similar transaction has recently been held to qualify under the new definition. See *Southland Ice Co. v. Commissioner* (1945) 5 T.C. 842.

⁵⁶ The final case in the series, *Helvering v. Cement Investors* (1942) 316 U.S. 527, was a taxpayer victory under section 112(b)(5), but its effect was too narrow to erase the distinction.

⁵⁷ Sen. Committee Print, H. REP. 3687, 78th Cong., 1st Sess. (1943) §115.

⁵⁸ This apparently would have overruled *Helvering v. Cement Investors* (1924) 316 U.S. 527.

⁵⁹ H. REP. 1079, 78th Cong., 2d Sess. (1944) 45-49.

"... the conference amendment . . . adds a new subsection (1) to section 112 of the code and provides that the effect shall be deemed to be included in the revenue laws respectively applicable to taxable years beginning after December 31, 1931. The new subsection provides for the nonrecognition of gain or loss to participating shareholders and *creditors*⁶⁰ in a reorganization described in new section 112(b)(10). Section 112(1) provides that no gain or loss shall be recognized upon the exchange of stock or securities of the old corporation solely for stock or securities in the new corporation."

Plainly the question whether various types of debt obligations are "securities" will be of the greatest importance under this new statute. The word "securities" is not defined in the statute and since it is not a word of precise inherent meaning its intended meaning must be aduced from its background and setting. As the new statute is *in pari materia* with the older tax-free exchange statutes, it may be assumed that the word "securities" is intended to mean the same in the new and old statutes.

It may be regretted that no explanation was made of the change of language in conference from "stock, securities or other obligations" to "stock or securities." The change must have been either because the words "or other obligations" were deemed unnecessary because included anyway in "securities," or because of a desire to narrow the scope and exclude "other obligations." There seems no basis for preference of either explanation over the other, without assuming the answer to the question of what obligations are included in "securities." The explanation if given would not, however, be a source of much relevant enlightenment unless it were accompanied by some indication of what the committee conceived would be "securities" and what would be "other obligations." The total absence of either such explanation makes the proposal and subsequent omission of the words "or other obligations" completely noncommittal.

Viewing the enacted provisions against the decisional background from which they sprang and in the light of their general purpose, they do indicate clearly enough that the word "securities" was intended to embrace a broader category of debt obligations than bonds alone. The definition in section 112(b)(10) of the insolvency proceeding which is to be given the same tax effect as a reorganization was deliberately made broad enough to cover both the *Alabama Asphaltic* and *South-*

⁶⁰ Emphasis added.

west Consolidated cases.⁶¹ Since the provisions of section 112(1), providing that no gain or loss should be recognized in a section 112(b)(10) transaction from the relinquishment or extinguishment of stock or securities in exchange for stock or securities in the new corporation, were intended to go hand in hand with those of section 112(b)(10), it is reasonable to believe that Congress intended section 112(1) also to be broad enough to apply to the debt obligations of the type involved in those two cases.⁶² This is so at least to the extent that those obligations were of a type which could rationally be described by the word "securities." Four types of debt obligations were involved in the *Alabama Asphaltic* and *Southwest Consolidated* cases. Unsecured notes taken for advances and otherwise unidentified obligations held by "small creditors" were involved in the former case, and bonds, unsecured notes and obligations of general creditors in the latter.⁶³ There should be no serious difficulty in concluding that Congress believed the bonds and unsecured notes⁶⁴ were "securities." There should be no insuperable difficulty in concluding that the obligations held by small and general creditors likewise are "securities" if they are evidenced by transferable notes. If, however, the obligations are merely accounts receivable evidenced only by invoices and book entries, there is a mechanical difficulty in thinking of them as "securities."

The general purpose of these provisions also supports a broad construction of the word "securities." The purpose is to make neither gain nor loss recognizable in an insolvency reorganization where the interest possessed prior thereto is not rendered worthless and wiped out. The idea is an extension of the theory that gain or loss is a paper profit or loss so long as the investments remain in the same business. Neither the purpose nor the theory stops with bonds or debentures. The interest

⁶¹ *Supra* notes 50 and 53. These are the decisions to which the Senate Committee referred by name in explaining the need for and intended scope of these provisions which it initiated. SEN. REP. NO. 627, 78th Cong., 1st Sess. (1943) 49.

⁶² This inference is strengthened by the fact that the conference report states that the section benefits "creditors," an all-inclusive term. Moreover, both Senate Finance Committee [SEN. REP. NO. 627, 78th Cong., 1st Sess. (1943) 50] and Conference Committee [H. REP. NO. 1079, 78th Cong., 2d Sess. (1944) 46] referred specifically by name to those cases whose facts and rules were not intended to be reached by the new provisions. It is therefore reasonable to suppose that had the committees believed all or a substantial portion of the debt obligations in any of the cases giving rise to the new statutes were not "securities" and hence would not be within the scope of the new statutes, they would have made reference to that fact.

⁶³ *Supra* notes 50 and 53.

⁶⁴ In *Commissioner v. Tyng* (C.C.A. 2d, 1939) 106 F. (2d) 55, *rev'd* on other grounds (1940) 308 U.S. 527, unsecured bonds were held to be "securities."

of a participating unsecured noteholder or trade creditor also remains invested in the business after the insolvency reorganization and it too may pay out in full if the business gets back on its feet. It follows, therefore, that the word "securities" should be given as broad an interpretation as is mechanically permissible.

The foregoing suggestion on casual consideration has the appearance of ignoring or overlooking *Pinellas Ice & Cold Storage Co. v. Commissioner*,⁶⁵ which held that certain short-term notes however well secured were not "securities" within section 112(b)(4).⁶⁶ It should be admitted that since section 112(b)(4) and section 112(l) are merely segments of the same larger pattern, the word "securities" has the same meaning when used in each of them. But the short-term purchase money notes in the *Pinellas* case were different in a vital characteristic from the short-term notes in, for example, the *Alabama Asphaltic* case. The *Pinellas* notes were essentially the equivalent of cash, whereas the outstanding characteristic of the *Alabama Asphaltic* notes was that they were not. The *Alabama Asphaltic* notes were, at the time they were exchanged for stock, essentially the equivalent of stock. This is the whole point of the Supreme Court's decision in the case, and it has as much relevance in determining whether obligations denote the right type of interest in the underlying assets so that they may be deemed "securities" as it has in determining whether the insolvency reorganization broke the proprietary interest. The logical difficulty in seeing how the wrong type of interest can be transformed into the right type without any intervening change in physical form or terms should present no barrier since the same logical difficulty was not a barrier in the *Alabama Asphaltic* case. The object is desirable, the result in keeping with the legislative purpose, and we have the evidence of our eyes that judicial prestidigitation is equal to the task.⁶⁷

⁶⁵ *Supra* note 25.

⁶⁶ The unsecured notes in the *Alabama Asphaltic* case were also short-term, being one-year notes. See *Alabama Asphaltic Limestone Co. v. Commissioner* (1940) 41 B.T.A. 324.

⁶⁷ The argument will doubtless be made, as it was in *Helvering v. Cement Investors* (1942) 316 U.S. 527, that, if the creditors now have a proprietary interest, whereas before they were mere creditors without such an interest, there must have been an exchange of a creditor's interest for a proprietary interest, which would be a taxable event recognizable under *LeTulle v. Scofield*. The court refused to consider this argument in the *Cement Investors* case so it may be regarded as still available. The answer to the argument is that in such a shift in interest there is neither sale, exchange, nor other disposition, so sections 111 and 112 are not brought into application. That there is no sale is obvious. There is no "exchange" ["... 'exchange' ... implies reciprocal transfers of capital assets, not a single transfer to compensate for the destruction

The foregoing lengthy legislative and judicial history should mean that today, over twenty years after the reorganization and tax-free exchange provisions first appeared in substantially their present form, the long desired predictability and certainty in their application have been attained, except for certain borderline questions about "securities." The troublesome parenthetical clause which was the cause of virtually all the uncertainty and litigation is gone. The definition of reorganization has been rewritten and confined, with the retouched portions representing a high degree of precision. The Supreme Court has had one occasion to interpret its language and has interpreted the new definition literally,⁶⁸ refusing to strain it to read into it the same meaning the court had found in the parenthetical clause.⁶⁹

Unfortunately, however, the goal of predictability and certainty is at present no closer than it ever was. Recent decisions by the Tax Court and some of the circuit courts of appeals have recreated doubts that were thought resolved as to the meaning of "securities," and have dimmed the theretofore precise meaning of the new definition of "reorganization."⁷⁰ If there is a debt obligation in the picture, it is a brave counsellor who today will give an unqualified opinion that a corporate readjustment is a reorganization in which exchanges are tax-free.

of the transferee's asset." *Helvering v. Flaccus Leather Co.* (1941) 313 U.S. 247, 249] because the creditor gives up nothing: he acquires new rights, perhaps (though it is believed that the sounder view in this context is that he acquires nothing new but merely arrives at the moment of possession and exercise of rights which were already inchoately his should the necessity for their exercise to protect his contractual right—that to be paid—ever materialize), but absent a giving up of rights there can be no exchange. For the same reason this is also no "other disposition." The creditor's old rights are still his and it is in the exercise of them that he assumes a new position. This analysis, if sound, is also the answer to the contention, should it be offered, that the creditor, by stepping into the new proprietary position, realizes ordinary income under section 22(a) as construed in *Helvering v. Bruun* (1940) 309 U.S. 461.

This argument, if sound, could have been made with equal validity under all the income tax statutes since 1913. But in that time it has never been considered that a creditor could receive income from the debtor's becoming unable to discharge the debt, nor has it been considered that the creditor's loss was sustained prior to the occurrence of an identifiable event, such as a finding of bankruptcy or a judicial sale to creditors, fixing the fact of loss. In consequence, the threat offered by the argument is probably not very serious.

⁶⁸ *Helvering v. Southwest Consolidated Corp.*, *supra* note 53.

⁶⁹ *Helvering v. Alabama Asphaltic Limestone Co.*, *supra* note 50.

⁷⁰ A third cause of the current uncertainty, the Tax Court's recent expansion of the doctrine of *Gregory v. Helvering* (1935) 293 U.S. 465, in cases such as *Adams v. Commissioner* (1945) 5 T.C. 351, and *Bazley v. Commissioner* (1945) 4 T.C. 897, *aff'd* (Jan. 8, 1946, C.C.A. 3d) 46-1 U.S.T.C. 9135, is beyond the scope of this article.

The difficulty which has arisen with the definition of "reorganization" lies in the effort of the courts to apply to the new precise definition the rule of interpretation evolved for the old parenthetical clause. This rule, the so-called continuity of interest test, has been applied mechanically in some instances and has been held inapplicable in others. The reason for the selection is not apparent from the statute.

There are two clauses in the present definition⁷¹ which do not by their plain and necessary meaning make any reference to the continuity of interest test wholly superfluous. These clauses are "(A) a statutory merger or consolidation," and "(E) a recapitalization." Of the two clauses, (A) is the more precise, due to the presence of the word "statutory." The Senate Finance Committee report⁷² shows that this clause was intended to mean exactly what it seems to say: a transaction carried out pursuant to a state statute "providing for mergers and consolidations." The relevant inquiry is simply whether the transaction was a merger or consolidation under the applicable state statute. Any uncertainty should be only in ascertaining the effect of the transaction under state law.⁷³ The meaning of clause E, on the other hand, is clear enough in a general way but since it rests on general concepts of corporation law instead of the effect of the statutes of some one specific state, its precise delimitations are less certain.

Yet curiously enough the more specific clause A has been limited more by an application of an overriding continuity of interest gloss

⁷¹ I.R.C. §112(g)(1): "The term 'reorganization' means (A) a statutory merger or consolidation, or (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, or (C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of substantially all the properties of another corporation, but in determining whether the exchange is solely for voting stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded, or (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its shareholders or both are in control of the corporation to which the assets are transferred, or (E) a recapitalization, or (F) a mere change in identity, form, or place of organization, however effected."

⁷² SEN. REP. NO. 558, 73d Cong., 2d Sess. (1934); 1939-1 CUM. BUL. (Pt. 2), 586, 598.

⁷³ If the reference in *Roebeling v. Commissioner*, next to be discussed, to the incapacity of state law was intended to deny the controlling effect of state law, it overlooks the fact that where the federal statute expressly or by necessary implication makes its application dependent on state law, the state interpretation of it is controlling. *Blair v. Commissioner* (1937) 300 U.S. 5; *Estate of Rogers v. Commissioner* (1943) 320 U.S. 410.

than has the less specific clause E. In *Roebeling v. Commissioner*,⁷⁴ a corporation, the properties of which were subject to a long term lease to an operating lessee, merged with the operating lessee pursuant to a New Jersey merger statute. An earlier agreement for a statutory merger calling for the lessor's shareholders receiving callable 6% cumulative preferred stock of the lessee had been enjoined by the minority shareholders of the lessor as unfair to them. The merger agreement finally adopted provided, as the New Jersey merger statute permitted, that the shareholders of the lessor corporation should receive 8% one hundred-year first mortgage bonds of the lessee. A shareholder contended that his gain on the exchange of stock for bonds was not taxable because it was an exchange of stock for securities pursuant to a reorganization and accordingly was non-taxable under the 1938 Act. The third circuit court of appeals held as had the Tax Court that, although the new definition of reorganization was literally satisfied since there was a statutory merger, under *LeTulle v. Scofield*,^{74a} there was not a reorganization. The application of *LeTulle v. Scofield* was mechanical; the opinion offers no evidence that the court saw any significance in the fact that it was not asked to interpret the statutory provision the *LeTulle* case involved but a different one altogether. The court did, however, state that the new definition of reorganization like the old one was not to be applied literally, and for this it cited two cases which made similar broad statements but fell considerably short of supporting the decision actually rendered. One of them, *Commissioner v. Gilmore's Estate*⁷⁵ was an earlier decision by the same court which held that a statutory merger was a reorganization under the new statute since it was not a sham to be condemned under *Gregory v. Helvering*.^{75a} An argument that the new statute states its own sufficient continuity of interest test is not answered by a statement that a sham reorganization will be disregarded even though it fits the literal language of the statute. The other case, *Morgan Mfg. Co. v. Commissioner*,^{75b} involved a plan for a sale of assets for cash in which the intermediate steps constituted a statutory merger. Since under the new definition as well as the old intermediate procedural devices are to be disregarded,⁷⁶ the statutory merger had to be disregarded as an

⁷⁴ (C.C.A. 3d, 1944) 143 F. (2d) 810; *cert. den.* (1944) 323 U.S. 773.

^{74a} *Supra* note 42.

⁷⁵ (C.C.A. 3d, 1942) 130 F. (2d) 791.

^{75a} (1935) 293 U.S. 465.

^{75b} (C.C.A. 4th, 1941) 124 F. (2d) 602.

⁷⁶ *Helvering v. Southwest Consolidated Corp.* (1942) 315 U.S. 194, 199-200.

intermediate procedural device and the transaction had to be treated as a sale for cash instead of a reorganization.

Under clause E of the new definition, however, transactions in which there was no continuing proprietary interest have been recognized as tax-free reorganizations.⁷⁷ Some of these cases involved the issuance of debentures in exchange for outstanding preferred stock of the same corporation, thus eliminating the preferred proprietary interest and substituting a creditor's interest (*Annis Furs, Inc. v. Commissioner, supra*; *Schoo v. Commissioner, supra*). Another involved an exchange by a solvent corporation of new preferred stock for an outstanding bond issue, thus creating a new proprietary interest (*Commissioner v. Capento Securities Corp., supra*). Still another involved an exchange of 20-year 6% debentures for 10-year 3¼% debentures (*Commissioner v. Neustadt's Trust*).⁷⁸ In some of these cases the reorganization issue seems not to have been vigorously fought by the Commissioner, but in others it was. The most complete statement of why *LeTulle v. Scofield* is regarded as inapplicable to recapitalizations may be found in the *Schoo* case, where the Board stated:^{78a}

"The respondent contends that the statutory word 'recapitalization' may not be read as meaning a type of statutory 'reorganization' unless through it persists a continuation of the same proprietary interest; and that a substitution of bonds for shares breaks the proprietary interest and substitutes a creditor interest. To support this argument, reliance is principally placed on *LeTulle v. Scofield*, 308 U.S. 415. This, however, is to take the *LeTulle* case out of its setting in the consideration of a 'merger or consolidation' of two corporations under subdivision (A), and to apply it to a recapitalization of a single corporation. As a contemplated result of the 'merger or consolidation' of two corporations, the individual taxpayer, for his shares in one of the corporations and other properties, received cash and bonds of the other corporation. This was something substantially different from what he gave up. It was not a mere reshaping of his interest in the same corporation through a recapitalization. In the present case, the substitution of the debentures for the preferred

⁷⁷ *Commissioner v. Capento Securities Corp.* (C.C.A. 1st, 1944) 140 F. (2d) 382; *Commissioner v. Neustadt's Trust* (C.C.A. 2d, 1942) 131 F. (2d) 528; *Annis Furs, Inc. v. Commissioner* (1943) 2 T.C. 1096, *Acq.* 1944 CUM. BULL. 2; *Schoo v. Commissioner* (1942) 47 B.T.A. 459; *Docherty v. Commissioner* (1942) 47 B.T.A. 462.

⁷⁸ This case was distinguished in the *Roebing* case, *supra*, on the ground that it involved facts and statutes different from those in the *Roebing* case. It may be felt that this distinction is not penetrating since it did not serve to distinguish the *LeTulle* case of which the same was true.

^{78a} (1942) 47 B.T.A. 459, 461.

shares was in substance not so much of a change as the words imply. In both, the holder was entitled only to dividends or interest out of income, and had no greater rights than unsecured creditors."

If the *LeTulle* case is regarded as applicable at all to the new definition, the foregoing distinction is not convincing. The continuity of interest test which culminated in the *LeTulle* decision was not derived from any language found in clause A as it existed before 1934. The test was born of the necessity of placing a sensible limitation on the literally unlimited language of the parenthetical clause in the old clause A. The test was derived from the general scheme and purpose of all the related provisions, including all the other portions of the old definition, of which the present clause E was a part.⁷⁹ It was held to be inherent in the entire statutory scheme and purpose and hence was to be read into the old clause A even though that clause did not state it expressly. It is difficult then to see why, if the test is not to be confined entirely to the old parenthetical clause, it should not be applied to the entire definition instead of merely to the new clause A.

There is, however, a reason to be found in the legislative history of the 1934 redefinition why the courts have correctly interpreted "recapitalization" in the foregoing cases. The House committee report discussed recapitalizations in connection with the desirability of continuing the non-recognition of losses incurred in reorganizations and in the course of the discussion used some significant examples. The committee commented on the fact that many corporations were in default on dividends on cumulative preferred stock and interest on bonds, and were recapitalizing to procure bank loans by transforming

⁷⁹ This is clearly evident from the opinion in *Cortland Specialty Co. v. Commissioner*, *supra* note 23 (which was approved and followed by the Supreme Court in *Pinellas Ice & Cold Storage Co. v. Commissioner*, *supra* note 25, where the court said [(1932) 60 F. (2d) 937, 940]:

"Section 203 of the Revenue Act of 1926 must be interpreted in this setting. Its purpose was to relieve those interested in corporations from profits taxes in cases where there was only a change in the corporate form in which business was conducted without an actual realization of any gain from an exchange of properties. When describing the kind of change in corporate structure that permits exemption from these taxes, section 203 does not disregard the necessity of continuity of interests under modified corporate forms. Such is the purpose of the word 'reorganization' in section 203(b)(3) of the act, 26 U.S.C.A. §934(b)(3), where a corporation exchanges its property 'solely for stock or securities.' Such also is the nature of the 'merger or consolidation' described in subdivision (h)(1)(A) The words 'A recapitalization' in subdivision (h)(1)(C) of section 203, 26 U.S.C.A. §934(h)(1)(C), and 'A mere change in . . . form . . . of organization, however effected,' in subdivision (h)(1)(D) of section 203, 26 U.S.C.A. §934(h)(1)(D), involved the same idea."

preferred stock into common and bonds into preferred stock.⁸⁰ The committee then stated: "If the reorganization provisions were omitted from the bill, these stockholders and bondholders could take large losses, although they still retain an interest in the corporation." Accordingly, in the words of the committee, it retained the reorganization provisions to "prevent large losses from being established by bondholders and stockholders who receive securities in a newly reorganized enterprise which are substantially the same as their original investments."⁸¹ Thus the committee construed the transfer into a proprietary interest of a creditor's interest in a solvent corporation as being a reorganization because, even though there was a complete change in the character of the interest, the same persons "still retain an interest in the corporation," an interest "substantially the same as their original investment." The point was, of course, just as it had been with respect to gains in 1921 and 1924, that so long as the investor retained an interest in the business which remained subject to the risk of loss and chance of enhancement, his gain or loss was only a paper profit or loss and should not be taken into account. It is entirely reasonable to conclude that the committee would have seen no difference between the examples it used and a case where holders of dividend-delinquent cumulative preferred shares were unwilling to have their interests stepped down into common stock but were willing to accept, in full exchange for their rights under the preferred stock, debentures carrying an interest rate lower than the preferred dividend rate with priority ahead of general creditors but junior to the needed bank loans. Some such variation of the situation referred to in the committee report is common enough, and the same reasons would impel a purpose to disallow the present deduction of any paper loss sustained on the exchange of preferred stock for debentures. If the investors still retain the necessary interest notwithstanding a shift from creditor of a solvent corporation to proprietor, the conclusion is easily enough reached that the necessary interest is also retained where the shift is in reverse—from proprietor to creditor.

In the draft bill accompanying the committee report just discussed, clause A of the present definition was to be found in exactly the same form as in the law today.⁸² There is no apparent reason for

⁸⁰ For text, see *supra* page 9.

⁸¹ *Ibid.*

⁸² I.R.C. §112(g)(1): "The term 'reorganization' means (A) a statutory merger or consolidation, . . ."

believing that Congress in 1934 intended to allow a loss to be taken under clause A which would be disallowed if brought about under clause E. On the contrary, the reasonable conclusion is that Congress wished the losses (and by the same token also the gains) not to be recognized at all if the exchange relied on to establish realization of the loss (or gain) was of a type which did not deprive the investor of a "retain(ed) interest" in the business "substantially the same as (the) original investment." To achieve similarity of treatment is why the statute defines a number of different transactions as "reorganizations" and prescribes the same tax consequences for all "reorganizations." Therefore the conclusion should be reached that Congress would not have wished a loss to be recognized merely because brought about under clause A instead of under clause E, where the retained interest was identical in each instance. It is possible to effect a statutory merger under New Jersey law in which stockholders of a constituent corporation become bondholders of the continuing corporation, and apparently conversely possible for bondholders of a constituent corporation to become stockholders of the continuing corporation. Plainly Congress would not have wished a loss or gain to be recognized in such a merger when the interest retained by the investor is in substance identical to that the retention of which would preclude recognition in a transaction defined by clause E.

It may be seen therefore that the gloss applied in the *Roebbling* case to nullify the literal language of the new definition is not only productive of serious and undesirable uncertainties in the application of the new definition but is in conflict with the inferences of congressional purpose which arise from the expressions of purpose in the legislative materials.⁸³ *LeTulle v. Scofield*, from which the third circuit imported the gloss, gives no measure of support at all to the importation since *LeTulle v. Scofield* involved a repealed portion of the statute which was wholly unprecise and plainly needed interpretative limitation. If a gloss proves to be needed by the new precise statute, the expressed legislative purpose permits that it be carried no further than the *Pinellas* case, which the legislative materials show was intended to be approved and embodied in the reworded definition. This, however,

⁸³ If the principle established in this case as a result of the Government's catch-as-catch-can tax litigation policy is accepted by other courts, an enticing avenue for establishing losses through New Jersey mergers is opened. Many holders of depressed preferred stock may be happy to accept debentures in exchange for their stock as the price of a tax deduction. The contrast of this eventuality with the Treasury's arguments in 1934 for retaining the tax-free reorganization statutes is ironic.

affords no support for concluding that the *LeTulle* doctrine was also intended to be embodied, for the *LeTulle* decision was not to come until six years after the new definition was adopted and, since the lower courts apparently without exception failed to foresee the *LeTulle* decision, it may be assumed that Congress as well failed to do so. Thus the failure of Congress to add an admonition directed to the courts that by its new definition it meant exactly what it said and not something else again is not the proper basis, at least in this situation, for an inference.

The interpretation of the new definition will indeed be off to a strange career if the interpretation of the old parenthetical clause is blindly applied to the new definition. It is impossible to make the facts in *Helvering v. Minnesota Tea Co.*⁸⁴ and in *John A. Nelson Co. v. Helvering*⁸⁵ fit the new definition, unless they should be statutory mergers or consolidations under the controlling state law, which is unlikely in view of the substantial cash consideration each involved. Both these sets of facts were, however, reorganizations under the old parenthetical clause. Of course the interpretation of the old parenthetical clause does not control the interpretation of the new definition and the Supreme Court has already so held in *Helvering v. Southwest Consolidated Corp.*, *supra*, which held the *Alabama Asphaltic* result impossible under the language of the new definition. *LeTulle v. Scofield* and the *Minnesota Tea* and *Nelson* cases all should be similarly declared inapplicable.

The present state of the case law in this sphere is uncertain, confused and, speaking solely of the *Roebbling* case, erroneous. It is to be hoped the Supreme Court will soon find occasion to correct and illuminate it by putting *LeTulle v. Scofield* in its place.

There is even more persistent and growing uncertainty as to the meaning of the word "securities."⁸⁶ Within limits some uncertainty is inevitable since Congress did not define the word.⁸⁷ Considerable un-

⁸⁴ *Supra* note 34.

⁸⁵ *Supra* note 37.

⁸⁶ Thus the Government has appealed (464 Federal C.C.H. Tax Reporter, p. 11,856) the decision of the Tax Court in *Pan American Trust Co. v. Commissioner*, T. C. Memo Op., May 28, 1945 [C.C.H. Dec. 14, 587 (M)], that registered secured notes of the B. & O. Railroad Co., due in five years but callable on thirty days notice, with coupons, were "securities." Notwithstanding the *Watts* case, in the present state of lower court confusion the issue in this case is in real doubt. Yet Congress in 1921 when it first used the word "securities" in the present context doubtless would have looked upon the Government's case as frivolous.

⁸⁷ But the degree of uncertainty fairly attributable to the lack of definition may not

certainty was engendered by the distinction drawn in the *Pinellas* and *Watts* cases between long-term and short-term obligations and this uncertainty produced a volume of litigation in the lower tribunals which succeeded in confining but not entirely dispelling the area of uncertainty. The Supreme Court has not to date indicated where the line is to be drawn between the short-term obligations which are not "securities" and the long-term obligations which are. Curiously enough, however, a new area of uncertainty has developed through the impression prevailing in some courts that in *LeTulle v. Scofield* the Supreme Court did draw this line, or did in some way indicate the true meaning of the word "securities."

The latter uncertainty being the latest is the most appropriate for the first discussion. It is ideally illustrated by the case which created it, *Neville Coke & Chemical Co. v. Commissioner*.⁸⁸ Two corporations had made advances and sold on credit to a customer which eventually became insolvent. These creditor corporations created the taxpayer for the purpose of holding and pressing all their claims against and investments in the insolvent corporation, which consisted of first mortgage bonds, accounts receivable, notes due in three, four and five years without interest, and stock. A 77B reorganization of the debtor ensued and in it the debtor issued new debentures to the old bondholders, new debentures and common stock to the noteholders and holders of other unsecured indebtedness, and some common stock to the old stockholders. The decision upheld the Commissioner's determination that the taxable gain realized from the transaction was recognized because the notes which the taxpayer exchanged for debentures and stock were not "securities." The opinion of the circuit court of appeals is the most articulate and interesting explanation of the decision. After suggesting that the notes were short-term obligations and therefore were not "securities" under various decisions, the court stated that in *LeTulle v. Scofield*, *supra*, the Supreme Court had held that "the term of the obligations is not material" and from this the court concluded that the notes could not be "securities" unless they represented a proprietary interest in the enterprise. The court decided that the fact that the taxpayer's shareholders were represented on the

be large. Two cases, the *Pinellas* and *Watts* cases, have been decided in the Supreme Court in which the meaning of "securities" was litigated. But these same two and five others discussed in this article, plus a few additional ones, have litigated the meaning of "reorganization," which word was defined.

⁸⁸ (1944) 3 T.C. 113; *aff'd* (C.C.A. 3d, 1945) 148 F. (2d) 599; *cert. den.* October 8, 1945, No. 149, October Term, 1945.

debtor's directorate pursuant to a creditors' forbearance agreement did not have any relevance to the taxpayer's position, which was thus merely that of creditor. The court also concluded that a provision in the notes granting an option to convert into stock did not give a proprietary interest until the option was exercised, which it was not. Only on the latter point does *LeTulle v. Scofield* afford the decision support.

The position taken by the third circuit thus is that *LeTulle v. Scofield* overruled the *Watts* case,⁸⁹ which had held that bonds not representing a proprietary interest are "securities." As has been pointed out at some length elsewhere,⁹⁰ in the *LeTulle* case the court had the opportunity to overrule the *Watts* case but instead of doing so it cited that decision approvingly as representing the state of the law. It decided instead that no reorganization occurred where property was exchanged for cash and bonds; this question did not depend to any degree on the status of the bonds as "securities." Addressing itself to the issue it was deciding, the court used the language quoted above⁹¹ which was also quoted and made the point of decision by the circuit court in the *Neville Coke* case. The latter court thus pulled the language out of context with the resultant distortion such excisions are noted for producing. If the decision were correct on this ground, it would mean that neither bonds nor any other debt obligations could be "securities"⁹² and thus any exchange of bonds for stock or stock for debentures in a recapitalization would result in recognizable gain or loss contrary to the position taken in the 1934 committee reports.^{92a} So, even viewing the problem as one not laid at rest by the *Watts* case, the decision is nonetheless insupportable.⁹³

⁸⁹ *Helvering v. Watts*, *supra* note 38.

⁹⁰ *Supra* pp. 12 and 13.

⁹¹ "... the term of the obligations is not material . . ."

⁹² There have doubtless been thousands of reorganizations and section 112(b)(5) transactions since 1921 in which long-term bonds and debentures have been exchanged or received tax-free, both government and taxpayer treating them as "securities" in complete good faith. Under the *Neville Coke* case the holders of such obligations can now claim stepped-up bases, with the result that the gain realized on their exchange or receipt will escape taxation altogether. Section 3801 will not rescue the government from its predicament in the numerous cases of obligations acquired or exchanged before 1932. The financial aspects of the rules announced in the government victory in this case are therefore not altogether in the Treasury's favor. *Cf. United States v. Hendler* (1938) 303 U.S. 564, and the retroactive provisions overruling it in section 112(b)(5), section 112(g)(1)(C), and section 112(K). These provisions were added in 1939 after the government's *Hendler* victory to "afford relief both to the Government and to the taxpayer." H. REP. NO. 855, 76th Cong., 1st Sess., 1939-2 CUM. BULL. 507.

^{92a} See text, *supra* page 9.

⁹³ Moreover, if "securities" includes no debt obligations, it can refer only to delin-

The *Neville Coke* decision is questionable and productive of dangerous uncertainty for another reason as well, a reason apparently not considered by either the Tax Court or the circuit court of appeals. The debtor corporation in the case was reorganized under section 77B and therefore was evidently insolvent in the equity sense. The rights of its creditors had thus grown until they became proprietary in character, capable of displacing the stockholders' interests altogether if necessary to protect the creditors. *Helvering v. Alabama Asphaltic etc. Co.*⁹⁴ While the creditors had not become technical "stockholders" by virtue of the insolvency (*Helvering v. Southwest Consolidated Corp.*),⁹⁵ they did become possessors of the dominant proprietary interest (*Helvering v. Alabama Asphaltic etc. Co.*; *Helvering v. Southwest Consolidated Corp.*).⁹⁶ Thus, even if the circuit court were correct in its interpretation of *LeTulle v. Scofield* as holding that the existence of a proprietary interest is required of all "securities," it would seem to have failed to apply the qualification of the rule of that case in subsequent decisions.

The reality of the possibility of confusion arising from the third circuit's expressed view that *LeTulle v. Scofield* had something to do with the meaning of the word "securities" is well evidenced by the even more recent decision in *Bedford v. Commissioner*,^{96a} in which the second circuit expressed the same view. The relevant essence of a rather complicated fact structure was that pursuant to a 77B reorganization a taxpayer received preferred stock of a new corporation in exchange for the guaranty of an old corporation securing the obligation of another old corporation to pay preferred stock dividends. The court held that the written guaranty could not be regarded as a "security" because the holders of the guaranty were general creditors of the guarantor and the test of "securities" requires "a continuing interest in the enterprise different from that of a general creditor."⁹⁷ As authority for this statement the court cited *LeTulle v. Scofield* and the *Alabama Asphaltic* case, in addition to an earlier decision of its

quent dividend rights [*Skenandoa Rayon Corp. v. Commissioner* (C.C.A. 2d, 1941) 122 F. (2d) 268, *cert. den.* (1941) 314 U.S. 696] and voting trust certificates. If so, one wonders why this unimportant word figures so prominently in the statute.

⁹⁴ *Supra* note 50.

⁹⁵ *Supra* note 53.

⁹⁶ See particularly (1942) 315 U.S. 194, 202.

^{96a} (C.C.A. 2d, 1945) 150 F. (2d) 341.

⁹⁷ *Ibid.* at 343.

own.⁹⁸ As the court elsewhere in its opinion cites the *Neville Cake* case, one gathers, that the statement quoted above was carefully tailored to show that the court did not agree with the third circuit view that the *Watts* case has been overruled. The court did, nonetheless, misunderstand the applicable Supreme Court decisions, which have refused to draw a line between secured and unsecured obligations. As discussed above, *LeTulle v. Scofield* is not a decision as to the meaning of "securities." But if it were, the case would refute the second circuit's understanding of it for the obligations in it were first mortgage bonds, and if it is to be interpreted as shedding light on "securities" then it must have held long-term first mortgage bonds were not "securities" and therefore must, as the third circuit held, have overruled the *Watts* case. How the second circuit found support for its statement in the second of the cases cited by it, the *Alabama Asphaltic* case, must remain a mystery. That case held that a transaction involving short-term notes was a reorganization for reasons discussed heretofore, and the portion of the opinion cited by the second circuit was devoted entirely to a discussion of the development of the interpretation of the old parenthetical clause in the definition of reorganization. Finally, the court overlooked entirely the fact that the distinction it sought to make between general creditors and secured creditors had been urged and rejected in *Pinellas Ice & Cold Storage Co. v. Commissioner*⁹⁹ in which the Supreme Court held that short-term notes secured by a first mortgage were not "securities" because being of such short-term character they were essentially equivalent to cash.

The second circuit also held that the provisions added by the 1943 Act designed to make insolvency reorganizations tax-free were inapplicable, for two reasons: (1) the guaranty rights were not "securities;" (2) the new provisions are inapplicable to recapitalizations since they apply only to reorganizations in which the property of one corporation is transferred to another. On the second ground the court was unquestionably correct, as both the text of the statute and the committee report cited by the court evidence. The 1943 amendments were designed to restore the *Alabama Asphaltic* result under current law

⁹⁸ *Lloyd-Smith v. Commissioner* (C.C.A. 2d, 1941) 116 F. (2d) 642, *cert. den.* (1941) 313 U.S. 588, holding unsecured two-year notes were not "securities." Oddly enough, in this case the court considered the *LeTulle* case at length and interpreted it with precision and accuracy.

⁹⁹ *Supra* note 25.

where the *Southwest Consolidated* case had held it unobtainable, and in the opinion in the latter case¹⁰⁰ the Supreme Court indicated that an insolvency reorganization would be a recapitalization and within the definition of reorganization if the original corporate entity was retained and there was no transfer of corporate property. On the first ground, however, the decision is both incorrect and a warning. It is a warning because it shows that the courts will tend to construe the 1943 amendments so narrowly that they will block the attainment of the purposes of those amendments. Certainly one cannot say that in this case the background which gave the amendments birth and indicates their purpose was looked to for enlightenment. This ground of decision is incorrect because it ignores the fact that as creditors of an insolvent corporation these holders of the guaranty had become possessors of a proprietary interest superior to that of the stockholders (*Helvering v. Alabama Asphaltic Limestone Corp.*, *supra*), and thus the continuing interest test the court was attempting to apply should have led it to the opposite conclusion from that which it reached.¹⁰¹

The *Neville Coke* and *Bedford* decisions thus evidence a large and growing uncertainty as to the meaning of "securities" and a tendency to get off on the wrong foot in consideration of problems which will be routine in the application of the 1943 amendments. Plainly this is a serious matter.

Both the questions discussed herein, *i.e.*, whether *LeTulle v. Scofield* is to be applied to the current definition of reorganization and the question of the meaning of the word "securities," are of importance in the interpretation of the revenue laws. There is currently complete confusion among the lower courts on both these questions, and to a large degree it arises from a single source, the decision of the Supreme Court in *LeTulle v. Scofield* and in the other cases in which that court created the continuity of interest doctrine and applied it to the old parenthetical clause. Since the doctrine is the Supreme Court's creation, only that court can determine where it stops. At least with the definition of "reorganization" the problem is not one Congress can settle: the problem is whether having spoken Congress will be taken at its word. Since the doubts arise from Supreme

¹⁰⁰ (1942) 315 U.S. 194, 202.

¹⁰¹ This same court held rights to delinquent dividends were "securities" ("a curious security to be sure, but nevertheless a 'security'") in *Skenandoa Rayon Corp. v. Commissioner* (C.C.A. 2d, 1944) 122 F. (2d) 268, *cert. den.* (1941) 314 U.S. 696. Here it distinguished that decision on the ground the dividend rights in it were of a proprietary nature. The discussion in the text is believed to show this distinction will not bear analysis.

Court doctrine, only that court can settle the doubts and it ought to do so as soon as possible.

On the question of "securities" the problem is one on which Congress could do more. But that has been true on this very question since 1921 during which time Congress has left the word for judicial definition. It is not greatly to the credit of the courts that after twenty-four years the meaning of the word is subject to increasing uncertainty. The uncertainty does not seem to be of the type the Tax Court can dispel authoritatively, because the problem is one of the meaning of Supreme Court decisions and statutes, not of facts or accounting methods.¹⁰² The Treasury could narrow the area of uncertainty considerably by a regulation defining "securities" with some particularity instead of merely stating its understanding of the Supreme Court doctrine in the most general possible way, but as this would commit the Treasury to taking the same position in gain cases as in loss cases, such a regulation may not soon be forthcoming.¹⁰³ The problem seems then to land squarely at the bar of the Supreme Court and the sooner it sees it there the better.¹⁰⁴

It is submitted that twenty-four years of uncertainty are enough. The new, precise definition of reorganization says exactly what Congress wanted it to say after years of experience with the faults of the old had showed Congress what improvements were needed. The statute should then be interpreted literally, free of any carry-over from the gloss placed on a deleted portion. A statutory merger should be a reorganization because the statute says it is.

The word "securities" cannot be so simply clarified since it is not a word with precise inherent meaning.¹⁰⁵ It should be treated here as

¹⁰² *Claridge Apartments Co. v. Commissioner* (1944) 323 U.S. 141; *cf. Trust of Bingham v. Commissioner* (1945) 325 U.S. 365.

¹⁰³ While it was hoped that the enactment of section 3801 would enable the Bureau to assume a position and adhere to it on both sides of the problem without fear of endangering the fisc, enough time has elapsed since the enactment of section 3801 to enable judgment to be passed on its efficacy in this regard. Notwithstanding that it affords the Bureau adequate protection, section 3801 has not had the desired effect on the Bureau's practice of inconsistent positions.

¹⁰⁴ Unfortunately the court denied certiorari in an excellent vehicle, *Neville Coke & Chemical Co. v. Commissioner*, *supra* note 88, *cert. den.* October 8, 1945, No. 149, October Term 1945.

¹⁰⁵ Courts have sometimes talked as though it were. Thus in *Commissioner v. Neustadt's Trust* (C.C.A. 2d, 1942) 131 F. (2d) 528, the second circuit stated that the word "securities" has a "well defined meaning in the business world" and that Congress used the word with that meaning. Yet in *Skenandoa Rayon Corp. v. Commissioner* (C.C.A. 2d, 1941) 122 F. (2d) 268, *cert. den.* (1941) 314 U.S. 696, the same court held rights to

a word of art with meaning deriving from its context which it would not have in other contexts.¹⁰⁶ This statutory design affords guides which if consulted will suggest the answer to most of the problems. Recognition that "securities" on the giving up side of the exchange includes many types of debt obligations it does not include on the acquiring side of the exchange would constitute a significant advance.¹⁰⁷ Such recognition would give the 1943 amendments regarding insolvency reorganizations the effect Congress intended them to have. Then in connection with "securities" acquired in a reorganization,¹⁰⁸ the Supreme Court decisions on the subject thus far have held that first mortgage notes maturing a few months after issuance were not "securities" because essentially equivalent to cash and that first mortgage bonds with an average maturity of four years after issuance were "securities" because they were a continuing investment at the risk of the business. These decisions are, it is submitted, worthy of being followed. They make sense in relation to the purpose behind the statute. They still leave the line to be drawn somewhere

delinquent preferred dividends were "securities" though a "curious type to be sure" [(C.C.A. 2d, 1941) 122 F. (2d) 268, 270]. There is not unanimity though there is similarity in the various definitions of "securities" in the Blue Sky laws of the states and nation. The common practice is to include "notes" and "evidences of indebtedness" in such definitions, as does the Federal Securities Act [§(2)(1); 15 U.S.C. Sec. 77(b)(1); see *S.E.C. v. C. M. Joiner L. Corp.* (1943) 320 U.S. 344]. It may not be doubted that if there is indeed a well settled meaning to the word "securities" in the business world, that meaning to some extent either has been induced by or is reflected in these definitions.

¹⁰⁶ This statute was not designed to regulate the securities market. The circumstances in which it applies are the very antithesis of market transactions. This statute was designed to deny tax recognition to a transaction in which a stake or investment in a corporate business, represented by either stock or "securities," is continued in a form changed sufficiently from the original for the change to constitute a constitutionally taxable event, but where the change does not withdraw the stake or investment so far from the risk of the business as to insure that it will not be wiped out or diminished by a subsequent failure of the business.

¹⁰⁷ Such recognition has been specifically denied in *Neville Coke Co. v. Commissioner*, *supra*, and *Bedford v. Commissioner*, *supra*. It does not appear, however, that in these cases the point was made that on the court's own premises the Alabama Asphaltic case compelled that such recognition be given.

Other arguments for such recognition have been made in Griswold, "*Securities*" and "*Continuity of Interest*" (1945) 58 HARV. L. REV. 705.

¹⁰⁸ Debt obligations are ordinarily acquired in recapitalizations, and occasionally in statutory mergers or consolidations. In the latter, they are doubtless always long-term. In the former, they need not be. Since no other portion of the definition of reorganization except clause D, which requires an additional continuing proprietary interest, can be satisfied literally if debt obligations are received, the necessity for decision on short-term obligations will probably arise most frequently from recapitalizations and, of course, insolvency reorganizations.

between a few months and four years, but it does not matter so much where this line is drawn so long as it is actually drawn. Once the line is drawn, certainly will have been achieved, and in a field where Congress so emphatically wanted certainty and tried to provide it there is nothing unreasonable in asking the Supreme Court to do its part in attaining it.

The question whether debt obligations must be secured to be "securities" remains unanswered, and this notwithstanding that in the *Pinellas* case the court rejected the argument that the line was to be drawn between secured and unsecured obligations. To illustrate the uncertainty prevailing on this question, the second circuit court of appeals has answered the question both ways.¹⁰⁰ The relevant considerations point to the conclusion that debt obligations need not be secured to be "securities." The underlying question is of substance, not form. The statutes in question were designed to avoid the emphasis on form which ultimately prevailed in *United States v. Phellis*¹¹⁰ and related cases. Thus neither gain nor loss is to be recognized unless after the exchange the stockholder or securityholder has in substance freed his investment from the risks of the business. An unsecured obligation and a secured obligation both remain at the risk of the business; in fact, an unsecured obligation is neither so equal in value to cash nor so freed from the risks of the business as the secured one. Therefore each type of obligation can qualify as "securities" if their term is long enough so that the business risk to which they will be subjected is a risk in reality. Obviously a purchase money note payable in a few months, particularly when secured by the property sold, does not remain in substantial degree at the risk of the business. But a note or debenture due in four years may rationally be said to do so: a lot may happen to a business in four years. This is the approach the Supreme Court has taken in the *Pinellas* and *Watts* cases; it is believed to be the proper approach to the problem; it leads to an answer which can be made certain.

¹⁰⁰ In *Commissioner v. Tyng* (C.C.A. 2d, 1939) 106 F. (2d) 55, *rev'd* on other grounds in *Helvering v. Tyng* (1940) 308 U.S. 527, and in *L. & E. Stirn, Inc. v. Commissioner* (C.C.A. 2d, 1939) 107 F. (2d) 390, it held unsecured obligations could be "securities" if they satisfied the length of time requirement. In *Bedford v. Commissioner* (C.C.A. 2d, 1945) 150 F. (2d) 341, involving a debt obligation on the other side of the exchange which the court said made no difference, unsecured obligations as a class were held excluded.

¹¹⁰ *Supra* note 13.

The present uncertainty should, therefore, be ended in the interests of the attainment of the congressional objective after twenty-four years of struggling. To a large degree the uncertainty centers about the meaning of Supreme Court decisions. The *Dobson*¹¹¹ device cannot be relied on to dispel or control it. It is the Supreme Court's problem.

¹¹¹ *Dobson v. Commissioner* (1943) 321 U.S. 231.