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Corporate Reorganizations, Tax Planning and the Excess Profits Tax of 1950

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RANDOLPH PAUL properly has observed that the complexities attendant upon equitable distribution of federal taxes do not lend themselves to expression in the simple language of a pill advertisement. In the Internal Revenue Code, involution seems most apparent in the sections dealing with corporate reorganization and with excess profits taxes. The ultimate in involved verbiage is accordingly encountered in Parts II and III of the excess profits tax provisions of the Code, which concern the effect of reorganization on liability for such taxes. It is the modest aim of the following discussion to afford a compass—as adequate as possible in limited space—for steering the course of corporate expansion among the excess profits tax shoals. It is not intended to serve as a substitute for close and careful analysis of specific exceptions and limitations of various statutory provisions in the light of a particular case; it is hoped that the analysis hereafter will afford a starting point for investigation. Comment as to tax minimizing is given sparingly; even more than in the usual case, tax consequences here depend on such a multitude of factors that generalization is apt to be misleading. The effect of reorganizations occurring before the effective date of the Excess Profits Tax Act will be considered only incidentally inasmuch as the taxpayer will already be saved or beyond mortal help in most of those transactions. Since mutations in corporation reorganizations are endless, attention will be directed only to those problems which may be expected to recur frequently.

Most important, it is not believed that excess profits tax consequences of a transaction should necessarily be controlling in setting up a business transaction. Since the corporation tax rate on income above \$25,000 is set at 47%¹ and the maximum total tax (including excess profits) is 62%,² in most cases the effective rate of the excess profits tax will rest at 15%. It is this percentage that must be weighed against business convenience and the effect of the transaction for standard corporation income tax purposes. Nevertheless, this should not be permitted to obscure the fact that business

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¹ INT. REV. CODE §§ 13, 15. Section numbers used hereafter refer to the Internal Revenue Code.

² § 430 (a) (2).

transactions must be planned in the light of excess profits tax liability along with the other factor.

ACQUISITION BY ONE CORPORATION OF STOCK OR ASSETS OF ANOTHER

Alternatives which arise when Corporation *A* decides to take over Corporation *B* are limited only by the imagination of its officers. It may purchase the assets and going concern value of Corporation *B*, paying cash from reserves or borrowing funds for the purchase. *B* Corporation or its stockholders may be given stock in *A* Corporation in consideration for the transfer of *B*'s assets to *A*. It may purchase the stock of *B*. If both are close corporations, it may be possible to arrange for purchase of stock by *A*'s stockholders from *B*'s stockholders. Or a new corporation *C* may be formed in a consolidation to take over the assets of both *A* and *B* Corporations in return for *C* Corporation stock issued to the constituent corporations or their stockholders. There are, of course, other avenues. All have disparate tax consequences under the Excess Profits Tax Act of 1950.

Many of the answers to the excess profits tax problems raised by the foregoing transactions are found in Part II of the excess profits tax. An introductory word respecting that section is a necessary preliminary to further discussion. In general, the section concerns certain transactions where tax consequences are not recognized for standard corporate income tax purposes, usually where a corporation acquires assets of another corporation, sole proprietorship or a partnership in a merger, consolidation or liquidation. In such a case, the acquiring corporation may add to its own base earnings credit an amount which represents either the actual base period earnings of the corporation parting with assets, or the earnings attributable to those assets under the relief provisions of the Act, including Section 435 (e) and Sections 442 through 446. Those eligible to use this option are described as "acquiring corporations" and are carefully enumerated in Section 461 (a).³ It will be noted that some corporate transactions

³ 461(a): "ACQUIRING CORPORATION.—The term 'acquiring corporation' means—

"(1) A corporation which has acquired—

"(A) substantially all the properties of another corporation and the whole or a part of the consideration for the transfer of such properties is the transfer to such other corporation of all the stock of all classes (except qualifying shares) of the corporation which has acquired such properties, or

"(B) substantially all the properties of another corporation and the sole consideration for the transfer of such properties is the transfer to such other corporation of voting stock of the corporation which has acquired such properties, or

"(C) before December 1, 1950, properties of another corporation solely as paid-in surplus or a contribution to capital in respect of voting stock owned by such other corporation, or

"(D) substantially all the properties of a partnership in an exchange to which section 112(b)(5), or so much of section 112(c) or (e) as refers to section 112(b)(5) is applicable.

"(E) properties either from one or more corporations or from one or more partnerships or from one or more corporations and one or more partnerships, other than from a corporation exempt under section 101, in an exchange, not otherwise described in this subsection, to which section 112(b)(4) or (5), or so much of section 112(c) or (e) as refers to section 112(b)(4) or (5), is applicable.

"For the purpose of subparagraphs (B) and (C) in determining whether such voting stock

fall outside the scope of that section, and attention first will be directed to two cases in which the section has no application.

Purchase of Assets for Cash or Equivalent

Tax disadvantages may well arise in cases where *B* Corporation sells its assets to *A* for cash. Should *B* Corporation receive more than the adjusted basis for its assets (as seems probable in the current rising market) the excess would be taxed to it as capital gain.⁴ If the assets were first distributed to stockholders and then sold, the stockholders would have to walk the tight rope distinguishing the *Cumberland*⁵ and *Court Holding*⁶ decisions under which gain from the appreciation of assets might be taxed to *B* Corporation. These factors, of course, are important for corporate net income, rather than excess profits, tax purposes.

Since an increase in excess profits net income is the expected result of the expansion of *A*, it is proper to increase *A*'s excess profits credit. It may compute its credit for excess profits tax purposes either by reference to its base period average earnings (Section 435) or its invested capital (Sections 436, 437). If it takes the latter option, its credit will not be changed by the exchange of surplus cash for assets.⁷ If borrowed capital is used to pur-

or such paid-in surplus or contribution to capital is the sole consideration, 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. Subparagraph (C) shall apply only if the corporation transferring such properties is forthwith completely liquidated in pursuance of the plan under which the acquisition is made, and the transaction of which the acquisition is a part has the effect of a statutory merger or consolidation.

"(2) A corporation which has acquired property from another corporation in a transaction with respect to which gain or loss was not recognized under section 112(b)(6);

"(3) A corporation the result of a statutory merger of two or more corporations; or

"(4) A corporation the result of a statutory consolidation of two or more corporations."

Subsection (f) provides as follows:

"Sole Proprietorship.—For the purposes of sections 461(a)(1)(D), 461(b)(5), and 462(k), a business owned by a sole proprietorship shall be considered a partnership."

It is noted that in cases under §§ 461(a)(1)(D) and (E), 461(f), and 462(a) and (b), an acquiring corporation may obtain the benefit of the base period earnings of a partnership or a sole proprietorship. The question not infrequently arises: To what extent does death of a partner or sole proprietor or other change in the partnership structure affect its base period? Some decisions respecting this subject were made under the statute in effect during World War II, which was much like the current law. It has been held that death of a sole proprietor terminates the experience record of the proprietorship, *S. Klein on the Square, Inc.*, 14 T.C. 786 (1950); that death of a partner did not terminate its base period where the partnership agreement provided for continuation in the event of death, *Ransohoff's Inc.*, 9 T.C. 376 (1947); and that the base period was terminated in a case where two partners bought out a third, *E. T. Renfro Drug Co.*, 11 T.C. 994 (1948). Where the assets of a partnership were obtained by a corporation which issued stock to two partners but paid another cash (15% of the total assets), the benefits of this section were held not to apply, *Hawaiian Freight Forwarders, Ltd.*, 15 T.C. 35 (1950).

The statute is applicable to a case in which the sole stockholder of a corporation liquidated it, operated as a sole trader, and finally reassigned to a new corporation which he organized and controlled. In such an event the base period may be computed by adding the base period of the proprietorship to that of the first corporation, *Faigle Tool and Die Corp.*, 7 T.C. 236 (1946).

⁴ §§ 22(a); 117 (a) and (j).

⁵ *United States v. Cumberland Public Service Co.*, 338 U.S. 451 (1950).

⁶ *Commissioner v. Court Holding Co.*, 324 U.S. 331 (1945). Discussion of this problem is outside the scope of this article.

⁷ Additions to invested capital credit may be obtained only where new capital is brought in, § 438(c); no increase is authorized for more productive use of capital already held.

chase the assets, *A*'s invested capital credit will be increased under Section 439 to the extent of 75% of the capital borrowed.⁸ In addition, a deduction of 25% of the interest paid is authorized under Section 433 (a) (1) (N).

If *A* Corporation computes its excess profits credit on the average earnings method, adverse tax consequences are quite possible. Where surplus is used for the purchase, *A*'s credit will remain unchanged, for no new capital will be added to *A* Corporation under Section 435 (g). If *A* borrows cash for the purchase, its earnings credit will be increased to the extent of 12% of the capital addition under Section 435 (g);⁹ 75% of the amount borrowed is considered as capital addition;¹⁰ 25% of the interest paid is deductible from excess profits tax gross income under Section 433 (a) (1) (O).

The primary disadvantage to a purchase of assets of *B* by *A* lies in cases where *B* has a substantial excess profits credit based on average earnings. This credit may arise because of substantial actual earnings, or through eligibility for relief under the "growth formula" of Section 435(e), or under relief provisions of Sections 442 through 446. In such a case it would normally be desirable to add the base earnings of *B* to those of *A* to attain joint average earnings for the consolidated enterprise. But the average earnings of *B* Corporation are transferable to *A* Corporation only under the circumstances described in Section 461(a), which authorizes no such transfer in cases where the exchange is made for cash or property.

Consequently, tax considerations impel avoidance of cash purchase of substantially all of the assets of a corporation unless the seller has an undesirable excess profits credit based on average earnings.

So far as *A* Corporation is concerned, this conclusion is not substantially changed in a case where it acquires only a portion of the assets of *B* Corporation. *B*, however, retains any excess profits credit carry over, and continues to use its previous excess profits tax credit, notwithstanding the exchange of assets for cash. This may represent a temporarily favorable result for *B* if the monies received are not immediately invested, for *B* would have a credit based on its total assets notwithstanding that after the sale only a portion of the assets were industrially productive.

Acquisition of Assets in Exchange for Assets

Corporation income taxes normally do not arise where property used in business is exchanged solely for property of like kind.¹¹ Assuming that such an exchange is contemplated by *A* Corporation, no corporate income tax liability would result; the gain or loss is not recognized. But while carry over of the earnings credit of Corporation *B* is authorized for most tax free exchanges,¹² there is no such authorization in the excess profits tax statute

⁸ A corporation will be entitled to an invested capital credit of 12% of the borrowed capital which is included. § 438(a), (c) (3).

⁹ § 435(a) (1) (C).

¹⁰ § 435(g) (3) (C).

¹¹ § 112(b) (1).

¹² § 461(a), quoted *supra* note 3. See also SEN. REP. No. 2679, 81st Cong., 2d Sess. 37, 38 (1950) (hereafter referred to as Senate Report) and H. R. REP. No. 3142, 81st Cong., 2d Sess. 29, 64 (1950) (hereafter referred to as House Report).

in the case of exchanges of this type. Accordingly, exchange of the assets of *A* Corporation for those of *B* Corporation has substantially the same effect for excess profits tax purposes as the purchase of the assets of *B* Corporation for cash from reserves.¹³

*Transfer of A Corporation Stock to
B Corporation in Exchange for B's Assets*

Excess profits tax problems frequently become critical where substantially all the assets of *B* Corporation are obtained in exchange for stock of *A* Corporation which is given to *B*. Assuming that the requirements of Section 112 (b) (4) are met, gain or loss with respect to the transaction is not recognized for purposes of the corporation income tax. The manifold problems in determining when the requirements have been met are outside the scope of this discussion. It is important to note that for corporation income tax purposes, the earnings of *B* would be transferred to *A* for the purpose of determining whether subsequent distributions by *A* to its stockholders were from earnings under Section 115 (a).¹⁴ No corresponding transfer of *B*'s deficit would be available.¹⁵

A Corporation has three alternatives with respect to its excess profits tax credit. Using the invested capital credit, it can add the value of *B*'s assets to invested capital. If it uses the average base earnings credit, it can either increase the credit by adding the value of *B*'s assets as a capital addition, or add the base period earnings of *B* Corporation to its own. The alternatives are discussed hereafter.

(a) *Computation of credit on invested capital basis.* When *A* Corporation exchanges its stock for assets of *B*, it may combine the assets of both corporations in computing an invested capital credit after the transaction under Section 437. The invested capital credit is measured by the percentages set out in Section 437 (a): 12% per annum on assets less than \$5,000,000; 10% thereafter to \$10,000,000; and 8% over \$10,000,000. The circumstances under which the invested capital credit is increased are, however, curious. A credit is established under Section 438 for all "new capital additions" received during the tax year, equal to 12% of the new capital additions received, irrespective of the size of the corporation. Assets received in a tax free transaction of the kind now under discussion are, however, excluded from the benefits of that section.¹⁶ The net result of these provisions with respect to *A* Corporation here is as follows: The 12% credit rate is not available for corporations with assets over \$5,000,000. Since the assets are not added to equity invested capital as a "new capital addition," they cannot be included in equity capital until the beginning of the tax year following the transaction. Thus, if the taxpayer is on the calendar year basis

¹³ A minor exception should be noted. Where assets are exchanged for assets and one of the exchanging corporations is entitled to compute its credit on the historical invested capital basis (§ 458) some adjustments are required under § 471.

¹⁴ *Commissioner v. Sansome*, 60 F.2d 931 (3d Cir. 1932).

¹⁵ *Commissioner v. Phipps*, 336 U.S. 410 (1949).

¹⁶ Properties received under § 112(b)(3), (4), (5) and (10) constitute "excluded equity capital" under § 438(e).

and the transaction occurs on July 1, 1951, the acquiring taxpayer cannot use the assets to compute invested capital credit for the remainder of 1951 under Section 438. The additional assets will constitute "equity capital" (under Section 437 (c)) "as of the beginning of the taxable year" 1952, under Section 437 (b) (2) (A). Hence, the assets received in the transaction will be included in the equity capital base as of the first tax year following the transaction. No other credit is available.

Excess profits tax disadvantages where *A* uses an invested capital credit are apparent also in another quarter. The assets received are valued at cost less depreciation¹⁷ and are likely to be worth much more in the current rising market. Hence, the addition to invested capital is likely to represent a sum substantially less than the operative value of the assets. In short, where *A* uses the invested capital basis and proposes to continue to do so after absorbing *B*, acquisition of *B*'s assets in exchange for *A*'s stock is unsatisfactory from an excess profits tax viewpoint. Purchase of assets with borrowed capital, considered in the preceding section of this article, might well be preferable.

(b) *Computation of credit based on base period earnings: Capital Additions.* If *A* Corporation computes its excess profits credit on the basis of earnings, the credit may be increased under Section 435 (g) by the additional capital represented by the assets of *B*.¹⁸ The increase in the credit is an amount equal to 12% of such capital addition,¹⁹ which is computed on a daily basis: in substance, if the transaction took place on the first day of the tax year, twelve percent would be taken from the total value of the assets; if the transaction were completed on the next to the last day of the tax year, the credit would be 12% of one three hundred sixty-fifth of such value.²⁰

The advantage of such a new capital addition is substantial. It guarantees a reasonably fair increase in excess profits credit for *A* Corporation even though *A* finds it impossible or unwise to add the base period earnings of *B* to those of *A* under the third alternative (discussed in the following paragraphs) of combining the base period earnings credit of both corporations. Indeed, in the unlikely event that the cost of the assets is substantially excessive with respect to their earnings power, it might be desirable for *A* to use the capital addition method rather than combining base period earnings of *A* and *B*, notwithstanding that the assets received are included as a daily net capital addition on their adjusted basis.²¹ Actual computation in each case represents the only method of resolving this problem; but it is important to note that *A* has an option as to which course to pursue.

¹⁷ § 437(c): "... the amount attributable to each asset shall be determined by ascertaining the adjusted basis ... for determining gain upon sale or exchange." A different rule is applied under § 438, but that section is not applicable to this transaction.

¹⁸ § 435(a)(1)(C) provides that 12% of the "net capital addition" of a corporation for any year shall be added to its base earnings credit. § 435(g)(1) and (3) include property paid in for stock as a "capital addition."

¹⁹ *Ibid.*

²⁰ § 435(g)(1).

²¹ § 441(b).

(c) *Consolidation of base period earnings of A and B Corporations.* In lieu of the foregoing credits, Part II authorizes *A* Corporation to add to its actual base period earnings the actual base earnings of Corporation *B*.²² In such a case, *B* Corporation could no longer use the credit.²³ The merger of the base earnings record of *A* and *B* is accompanied by merger of their capital additions and reductions under Section 435 (g) where the merger is accomplished after the effective date of the Act.²⁴ In computing its capital changes after the transaction for purposes of that section, *A* would add (for the remainder of the tax year in which the transaction took place) the capital additions for *B* during that year.²⁵ It would likewise deduct *B*'s distributions to stockholders during that period.²⁶ In computing capital changes at the beginning of the next tax year, it would total the equity capital of both corporations at the beginning of their first tax years and compare that with total equity capital for the current tax year to measure a net capital increase or reduction for *A* Corporation.²⁷ Changes in borrowed capital²⁸ and inadmissibles²⁹ are similarly computed. Broad authority to interpret the statutes on this subject is given to the Commissioner, presumably to prevent duplication of credits.³⁰ Where *A* takes over only a portion of the assets of *B*, the same rules are effectual on an allocated basis.³¹ *A* and *B* may likewise be eligible for an additional credit because of capital additions under Section 435 (f) before the merger. These credits are similarly joined to compute the credit of *A* after the transaction.³²

If either *A* or *B* Corporation was in existence during all of the base period, but the other was not, the monthly excess profits credit of the corporation which was not in existence may be treated as equal to 1% of its

²² §§ 461(a), 462(a), (b). House Report p. 30: "Where a corporation computes its excess profits tax credit simply on the basis of its excess profits net income during the base period, the effect on part II is to provide that after the corporation acquires assets in an exchange described in part II it shall recompute its excess profits net income for each month of the base period prior to the exchange by combining its own earnings experience during those months with the earnings experience of the corporation whose assets it acquired." See also House Report, p. 66, and Senate Report, pp. 37, 38.

Problems not infrequently arise with respect to computing the base period income where *A* exchanges its stock for assets of a partnership. This is especially true where deductions for salary of the partners are sought and the partners actually received only their share of partnership profits as compensation or received only nominal consideration. The problem was considered under the similar World War II statute in *Vegetable Farms, Inc.*, 14 T.C. 850 (1950) and *Bernhardt-Strohmaier Co. v. U.S.*, 84 F. Supp. 51 (S.D. Cal. 1949).

²³ § 461(c). House Report, pp. 64, 65.

²⁴ See § 463. This section was discussed at some length in the House Report, p. 71. The House version was amended in some respects before passage, but the report is nevertheless informative. The subject is not discussed in the Senate Report.

²⁵ § 463(a) (1).

²⁶ § 463(a) (2).

²⁷ § 463(a) (3), (4).

²⁸ § 463(a) (5).

²⁹ § 463(a) (6).

³⁰ § 463(a) (4), (7). For a discussion of the power of the Commissioner to prevent duplication of credits under § 462(j), see notes 116 to 121, *infra*, and text.

³¹ § 463(a) (8) to (10).

³² § 464.

equity capital on the day before the exchange.³³ Should it appear that *A* Corporation owned stock in *B* Corporation during *A*'s base period, the credits are adjusted to eliminate a double counting of assets which would arise by reason of cash or property paid in by *A* to *B* originally in return for its stock.³⁴

In some cases *B* Corporation will not have a substantial earnings credit but may be entitled to a constructive base period earnings credit under the relief provisions of the Act. Under the so-called "growth formula,"³⁵ certain corporations whose payroll has increased 30% or whose gross receipts have increased 50% during the last half of its base period can select the highest credit which results from enumerated computations based on earnings during the last two years of the period. Where both *A* and *B* Corporations qualify for relief under the formula, *A* Corporation may use the formula with respect to the base period of both corporations.³⁶ In general, the formula cannot be used unless both are eligible³⁷ except in cases where the transaction occurred after the effective date of the excess profits tax act. In such an event, base earnings of the company which qualifies for relief under the growth formula may be computed thereunder and added to the earnings of the other company to reach the total base earnings.³⁸

Where *A* Corporation takes over only part of the assets of *B* Corporation under Section 112 (b) (4) and (5), a different result is obtained if *B* Corporation was entitled to use the growth formula and had begun business before its base period. Under the specific language of the statute, *A* Corporation is entitled to use the growth formula, provided the transaction takes place after the base period of *B*.³⁹ It is then immaterial that *A* Corporation was not previously entitled to use the formula. Thus, if *A* Corporation were almost qualified for the growth formula treatment during its base period, presumably it would be able to acquire and use the assets of *B* Corporation in qualifying for the formula. Of course, *A* Corporation in such a case would have to be sure that it did not take "substantially all" the assets of *B* Corporation; if that is done, the record of *B* Corporation cannot be used to

³³ § 462(b)(2). House Report, p. 30: "If the corporation whose assets were acquired was not in existence during a month in the base period in which the acquiring corporation was in existence, then the recomputation described above is made by combining the earnings of the acquiring corporation with 1 percent of the equity capital of the corporation whose assets were acquired (after adjustment for inadmissible assets)." See also Senate Report, p. 38.

³⁴ § 462(b): "In case either the acquiring corporation or any component corporation owned stock in any other such corporation on the first day of such owning corporation's first taxable year under this subchapter, the amounts computed under this paragraph with respect to such corporations shall be adjusted, under regulations prescribed by the Secretary, to such extent as may be necessary to prevent the excess profits net income of such corporations for the base period of the acquiring corporation from reflecting money or property having been paid in by either of such corporations to the other for stock or as paid-in surplus or as a contribution to capital, or from reflecting stock of either having been paid in for stock of the other or as paid-in surplus or as a contribution to capital." See also House Report, p. 67.

³⁵ Established under § 435(e).

³⁶ § 462(c)(1)(A).

³⁷ § 462(c)(1)(B). An exception is made in the so-called "television cases." See § 462(c)(3).

³⁸ § 462(c)(1)(B). See also House Report, pp. 30, 68.

³⁹ § 462(c)(2). The statute is unequivocal and the legislative history is clear. See House Report, p. 68.

qualify *A* Corporation for the growth formula.⁴⁰ Moreover, it is safe to assume that a business purpose in the transaction must be demonstrated and that it must be shown Section 129 is not applicable.⁴¹ What real or fancied equity underlies this result is not clear; certainly these provisions invite tax avoidance.

Other advantages may be obtained where *A* gives its stock in exchange for substantially all of *B*'s assets. Corporations may elect to take a base period income based on the industry rate of return if they had "abnormalities" in the base period, (Section 442(c), (d)), or changed their products or services, (Section 443), increased capacity for production or operation, (Section 444), or were classified within a depressed industry sub-group, (Section 446). These industry rates of return frequently approximate 12 to 14 percent on total assets and in some industries the rate is twenty-five percent.⁴² Use of these rates will not, of course, always result in an increased excess profits tax credit, especially since the rates will be computed on the adjusted basis that *A*'s assets had in the hands of *B*.⁴³ The statutes setting out the circumstances under which *A* may use industry rates are complex but reasonably clear. Such relief depends upon the specific requirements of each section authorizing a constructive base earnings period.

When the exchange takes place following the base period of *A*, relief is available to *A* in the event that prior to the transaction *A* was entitled to relief under one of these sections and *B* was likewise entitled to relief under the same or another of the sections in the base period.⁴⁴ Thus, where relief is sought on the basis of abnormalities and both *A* and *B* Corporations were entitled to compute base period earnings under Sections 442 through 446, the base period earnings of *B* may be computed under the abnormality

⁴⁰ § 462(c) (1) (A) and (B). It is not easy to say what constitutes "substantially all" of the properties of a corporation or partnership as that term is used in § 461(a). See Lasser, *Reorganizations and the Excess Profits Tax*, 20 N. Y. U. L. Q. 23 (1944). Two cases decided under the World War II Act deal with the subject but throw little light upon it because of unusual factual circumstances in each case. See *A. C. Burton Co.*, 14 T.C. 290 (1950) and *Hawaiian Freight Forwarders, Ltd.*, 15 T.C. 35 (1950).

⁴¹ It is impossible in this article to forecast the extent to which these doctrines may affect any reorganization. The business purpose rule stems generally from *Gregory v. Helvering*, 293 U.S. 465 (1935); *Higgins v. Smith*, 308 U.S. 473 (1940); and *Bazley v. Commissioner*, 331 U.S. 737 (1947). For excellent recent discussions of the doctrine, see *Lourie, The Business Purpose Doctrine*, 25 TAXES 800 (1947); *Spears, Corporate Business Purpose in Reorganization*, 3 TAX L. REV. 225 (1947). The scope of § 129 is almost equally uncertain, for there have been few decisions interpreting it. In general that section denies a "deduction, credit or other allowance" if a corporation gets property in a tax free transaction and the "principal purpose" of the acquisition is "avoidance or evasion" of Federal income or excess profits taxes by obtaining a benefit not otherwise enjoyed. The meaning of the section has been critically and competently considered. See *Rudick, Acquisitions to Avoid Income or Excess Profits Tax: Section 129 of the Internal Revenue Code*, 58 HARV. L. REV. 196 (1944); *Chase, An Analysis of Section 129 of the Internal Revenue Code*, 30 CORN. L. Q. 421 (1945); and *Barnard, Acquisitions for Tax Benefits*, 34 CALIF. L. REV. 36 (1946).

⁴² U. S. Treas. Reg. 130, § 40.447-2 (1951).

⁴³ Under § 113(a) (6), *A* takes the basis of *B* for the assets since they are received in a tax free transaction under § 112(b) to (e). Use of adjusted basis is required under §§ 442(f), 443(g), 444(g) and 445(c). The subject is not specifically covered by the provisions of § 446, although the same rule undoubtedly applies there.

⁴⁴ § 462(d) (2).

relief provisions and added to those of *A*, assuming that *A* was in existence before the beginning of its base period.⁴⁵ No constructive base period for *B* Corporation may be used by *A* unless both are entitled to compute their average base period earnings under Sections 442 through 446, all of which authorize the use of an industry rate of return in lieu of actual base earnings.⁴⁶ It will be seen that under these circumstances *A* Corporation will not improve its tax position by the exchange, since it may use a constructive base period income under Section 442 for the component only if the component was eligible for such relief before the transaction. In one situation the position of *A* may be impaired: if it is not entitled to relief on an industry rate of return basis under Sections 442 through 446, but *B* Corporation is so entitled, the net result of the merger will be that *B* Corporation rights to constructive base period earnings computed under the industry rate of return will be lost. In such a case the feasibility of purchasing the stock (rather than giving *A* stock for *B*'s assets) should be considered.⁴⁷ Assuming that both corporations were in business throughout the base period, the relief here discussed is available on an allocated basis to the assets transferred by *B* if *A* acquires only a portion of those assets.⁴⁸

The use of industry rates of return is also authorized under Section 443 in cases where corporations have changed their products or services in the latter part of their respective base periods. In no event may *A* Corporation use industry rates of return under Section 443 unless either *A* or *B* commences business prior to the base period.⁴⁹ If both *A* and *B* Corporations were entitled to compute their average earnings under the provisions of Section 442 (d) or Sections 443 through 446, relief under Section 443 is available in computing base period earnings for either company or both.⁵⁰ It may happen that either *A* or *B* was not qualified for relief under Section 443 at the time of the transaction but had made a substantial change in services or products furnished. In such a case, *A* Corporation can combine its base period with that of *B* Corporation and if the total would qualify for relief under Section 443, the relief will be available.⁵¹ This option is restricted, however, to cases where both corporations were in business during the entire base period.⁵² In addition, where *A* Corporation made a substantial change in its products or services after the transaction, it is entitled

⁴⁵ § 462(d)(2), (3).

⁴⁶ § 462(d)(2). As noted, the scope of this discussion is limited to cases where the transaction took place after the base period. If the transaction occurred during the base period, the assets, earnings, interest payments and abnormalities of both corporations through the entire base period of *A* are combined to measure the relief available under § 442. See § 462(d)(1).

⁴⁷ See notes 72 to 81 *infra* and text.

⁴⁸ § 462(d)(1)(B). Allocation is made under the rules set out in § 462(i). In general, these provide that the allocation is proportionate to the fair market value of the assets unless the parties and the Secretary agree to an allocation based on earnings. § 462(i)(6). See also House Report, pp. 29, 69; Senate Report, p. 39.

⁴⁹ § 462(e)(3).

⁵⁰ § 462(e)(1)(B).

⁵¹ § 462(e)(1)(C).

⁵² § 462(e)(1).

to determine its average base period income under Section 443.⁵³ The opportunity for tax avoidance seems manifest.

If *A* obtains only a portion of *B*'s assets, it is entitled to use the industry rate of return only where *B* Corporation was eligible for relief under Section 443 prior to the date of the transaction or *A* substantially changed its products or services after the transaction.⁵⁴ Literally, the statute seems to bar *A* from using Section 443 to compute its base earnings under such circumstances notwithstanding that it was entitled to such relief prior to the transaction. This result seems justified neither by logic nor expediency. It is noted that here, as in other cases, the average base period earnings of *B* are allocated to *A* as authorized under Section 462 (i).

Section 444 authorizes corporations to use industry rates of return in cases where capacity for production or operation was increased during the last three years of its base period. This relief is unavailable to any corporation which issues stock for assets in a tax free transaction under Section 461 (a), unless both corporations were eligible for relief under Sections 442 (d) through 446.⁵⁵ Thus, if either corporation were entitled to relief under Section 444, and the other were entitled to no relief under Section 442 (d) through Section 446, the rights of the eligible corporation would be lost by the exchange. This result would follow whether the exchange involved all or merely a portion of *B*'s assets.

Under Section 445, a corporation which began business after the first day of its base period and uses earnings to measure its credit may use the industry rate of return.⁵⁶ Where two companies are merged and either company began business after the beginning of its base period, the acquiring company may also use the industry rate of return, based on the assets of the companies valued as of dates specified in the statutes.⁵⁷ Where both com-

⁵³ It seems probable that while *A* may obtain this relief with respect to its own base period, only the actual base period earnings of *B* will be added to compute the total credit unless *B* was itself entitled to relief under § 442(d) through § 446. See § 462(e) (1) (E) and § 462(b) (3). An acquiring corporation is not deemed to have changed its products or services solely because of such a transaction. § 462(e) (1) (F).

⁵⁴ § 462(e) (2): "In the case of a transaction described in section 461(a) (1) (E), the acquiring corporation shall only be entitled to compute its average base period net income under section 443 where:

"(A) the component corporation was entitled to compute its average base period net income under section 443 prior to the date of the transaction, in which event such average base period net income shall be allocated as between the acquiring corporation and the component corporation in the manner provided in section 462(i), or

"(B) there was, after the date of the transaction, a substantial change in the products or services furnished by the acquiring corporation and the acquiring corporation determines its excess profits net income for each month of the base period by reference to the excess profits net income allocable to it in the manner provided in section 462(i)."

⁵⁵ § 462(f).

⁵⁶ § 445(a). This section recites that new corporations "shall" use the industry rate of return; however, Reg. 130, Section 40.445-1 (1951) recites that use of industry rates is optional. So does the House Report (p. 69). Indeed, the regulation cited requires that new corporations are not entitled to the benefits of § 445 unless they specifically apply therefor under § 447(e).

⁵⁷ § 462(g) (2).

panies began business before the beginning of their respective base periods, relief under Section 445 is not available.⁵⁸

A credit equal to 80% of industry rates of return is likewise authorized for depressed industries.⁵⁹ No relief is authorized following merger (as here) under Section 461 (a) unless both corporations were entitled, prior to merger, to the benefits of Section 442 (d) through Section 446. Here, also, where either corporation was entitled to relief under Section 446 and the other was not entitled to relief under Section 442 (d) through Section 446, benefits of the section would be lost to both after the merger. No distinction is made between cases in which *A* obtains a part, rather than all, of *B*'s assets.

It thus appears that substantial benefits may be obtained for excess profits tax purposes by exchanging *A*'s stock for *B*'s assets. This is particularly true since a corporation which has qualified for Part II treatment (as in this case) may accept the options granted under Part II but may also ignore that portion of the statute and proceed under an invested capital basis or compute an earnings credit with the additional credits available under Section 435 (g). The excess profits tax effect of a transaction may and should be computed in each case.

(d) *Tax consequences to B where a portion of its assets are exchanged for A stock.* The excess profits tax consequences to *A* have been discussed in cases where *A*'s stock is exchanged for a portion of *B*'s assets. So far as *B* Corporation is concerned, its excess profits tax carry over credit⁶⁰ seems to be applicable to it after transfer; the activity of that corporation has not ended. If, by the exchange of assets for stock, the income of *B* is reduced to the point that its total income is less than \$25,000, *B* would have no excess profits tax liability at all. Such a result might, however, invite close scrutiny by the Commissioner to see whether Section 129 and the business purpose rule had been violated.⁶¹

Where *B* is on the invested capital basis, its invested capital is reduced because it has substituted stock in the new company (an inadmissible asset) for admissible assets (property or cash).⁶² Of course, its income from the stock is eliminated from computation of its excess profits net income,⁶³ so there will be no excess profits tax loss if income from the stock equals previous income from the assets; a tax loss is obvious, however, to the extent that ordinary corporate income tax is effective as to 15% of the dividends received.⁶⁴

⁵⁸ § 462(g)(3).

⁵⁹ §§ 462, 446.

⁶⁰ Under § 432.

⁶¹ See note 41 *infra*.

⁶² The stock is designated as an inadmissible under § 440 and hence is excluded from equity capital under § 438(c) and (d).

⁶³ § 433(a)(1)(A).

⁶⁴ Income from *B*'s assets prior to the transaction is taxed to *B*; when distribution is made to *B*'s stockholders it is again taxed to the stockholders as a dividend. § 115(a). After the transaction, income from the assets is taxed first to *A*. When *A* distributes the income to *B* it is taxed to *B* as a dividend on *B*'s stock. *B* gets a credit of 85% of the dividends received under § 26. When *B* distributes to its stockholders the income is taxed to them in full as a dividend.

Where *B* computes its excess profits tax credit on base earnings under Section 435, its credit will be reduced under Section 435 (g) by 12% of the value of the assets distributed. There will be no compensating credit for the stock received since it is an inadmissible asset. However, where, as in the example here, the transaction is within the purview of Section 461 (a), *B* may compute its credit based on that proportion of its base period income represented by the assets retained after the transaction.⁶⁵ It would likewise lose, on an allocated basis, rights to new capital credit and capital increases during the base period.⁶⁶ Under the terms of the statute this option is available to *B* only where *A* computes its credit under Section 462 (b):⁶⁷ that is, if *A* computes its credit under Section 435 (g) or the invested capital method, *B* cannot compute its credit under Section 462 (i). Where *B* Corporation was entitled to relief under Section 442 (d) through Section 446, those rights are not lost after the transfer but are allocated under Section 462 (i).⁶⁸ It appears that *B* would lose all rights under the growth alternative to which it was entitled before the transaction, although the question is not free from doubt.⁶⁹

It is obvious that in none of those circumstances does *B* stand to improve its excess profits tax position by the transaction. But, except where it computes its credit on the invested capital basis, neither does *B* stand to lose, as long as *A* uses Section 462 (b).

(e) *Exchange of A stock for assets of partnership.* If *A* computes its excess profits credit under the invested capital method, it is, of course, immaterial that it exchanged its stock for the assets of a partnership rather than a corporation. It is equally immaterial where *A* computes its credit on

⁶⁵ § 461(c) (3). The result is succinctly summarized in the House Report, p. 29:

"In general, if all the properties of the corporation are taken over by another corporation in an exchange to which part II is applicable, the old corporation is no longer entitled to use its business experience prior to the exchange for purposes of computing average base period net income. Instead, the corporation which acquires the properties may use the experience of the corporation which gave them up if this will increase the acquiring corporation's average base period net income. In a case where only part of the assets of a corporation go over to a new corporation in an exchange in which gain or loss is not recognized, the old corporation loses that portion of its base period experience which is allocable to the assets it loses in the exchange, and the acquiring corporation may utilize such experience in computing its average base period net income. The allocation is proportionate to the fair market value of the assets unless the parties to the exchange agree on a different allocation and the Secretary consents to it."

See also Senate Report, p. 38.

Any additional credit of *B* which arose because of capital additions in its base period is not altogether lost, but is allocated under § 462 (i). See § 461(c) (3).

⁶⁶ §§ 463(a) (8) ; 464(b).

⁶⁷ § 462 (i).

⁶⁸ § 461(c) (3).

⁶⁹ § 461(c) (1) provides that a component corporation (here *B* Corporation) loses its base period income credit except as provided in later subsections. § 461(c) (3) provides in substance that where a corporation such as *B* transfers a portion of its assets it loses its base period earnings credit in the proportionate value of the assets transferred and on the same basis loses credits attributable to §§ 435(f), (g) and 442 through 446. No provision is made respecting § 435(e), which deals with the growth formula. Perhaps *B*'s benefits thereunder would be available at least on an allocated basis under § 462 (i) ; but under § 462(c) (2) it appears that under these circumstances the acquiring corporation could use *B*'s entire growth formula experience to obtain a base period credit after the transaction based on the growth formula. Accordingly, the issue remains in doubt.

the basis of capital additions under Section 435 (g). However, difficulties arise where *A* Corporation desires to add the base earnings of the partnership to its own under Part II in computing its excess profits credit. This procedure is authorized under Section 461(a) (1) (D) and (E) only where the acquisition conforms to the requirements of Section 112(b)(5). The latter section is applicable only where, after the transaction, the persons making the transfer were in control of the corporation. Relief under Part II accordingly will be unavailable in many cases.

*Transfer of A Corporation Stock to Stockholders
of B Corporation in Exchange for B's Assets*

The preceding section concerns the case where merger is accomplished by giving *B* Corporation the stock of *A* in exchange for the assets of *B* in a reorganization under Section 112 (b) (4). After such a reorganization, dividends are paid by *A* to *B* and thereafter to *B*'s stockholders. Under Section 26, *B* would get only an 85% dividends received credit for corporation income tax purposes so that 15% of the earnings of *A* would be taxed twice before receipt by *B*'s stockholders. To avoid this result, it might be thought advisable to transfer assets to *A* in exchange for the issuance of *A* stock directly to *B*'s stockholders under Section 112 (b) (3). No adverse excess profits tax consequences would appear to follow from such procedure so far as the invested capital credit and Section 435 (g) are involved.

As with other reorganization problems, prediction respecting the effectiveness of this procedure with respect to relief under Part II of the Act is dangerous. Nevertheless, it is clear that Section 461 (a) (3) specifically includes corporations which are the result of statutory mergers within the definition of "acquiring corporations" so as to be eligible for Part II relief. Depending on the law of the state in which the transaction is undertaken,⁷⁰ it seems probable that the transaction here described represents a statutory merger. It recently has been held that transfer of stock of the acquiring corporation to the shareholders of the corporation surrendering assets is tax free within Section 112 (b) (3).⁷¹ Accordingly, it is proper to anticipate that where this procedure is followed, *A* Corporation would have the same options as where it issued its stock to *B* instead of *B*'s stockholders. That is, it could add the base earnings of *B* to its own in determining its base earnings credit and obtain the other options extended in Part II.

Purchase by A Corporation of the Stock of B Corporation

It is possible that the industrial consequences sought by *A* Corporation may be secured by taking over *B* Corporation itself through a purchase of *B* stock from its stockholders. *B* Corporation itself would remain in existence. This might be advantageous to *B*'s stockholders since it would have the effect of transferring *B*'s assets to *A* without any gain being recognized to *B* Corporation as a result of the transfer. Accordingly the income tax

⁷⁰ § 112(g); U.S. Treas. Reg. 111, § 29.112(g)(2).

⁷¹ *Morley Cypress Trust*, 3 T.C. 84 (1944). The same conclusion was reached where § 112(b)(5) was involved. *Clyde Bacon, Inc.*, 4 T.C. 1107 (1945).

liability of *B* Corporation would be minimized, and the net gain of *B*'s stockholders would be greater than if *B* Corporation sold its assets and distributed the proceeds in liquidation.⁷²

Substantially different tax consequences for *A* Corporation also follow in such an event. *B* Corporation will, of course, retain its earnings record. Since both *A* and *B* maintain their separate entities, no problem arises concerning computation of a combined credit on either the invested capital or earnings basis. It has been noted that in many cases where either *A* or *B* Corporation is entitled to relief under Section 442 (d) through Section 446, this relief would be lost in the event that *A* Corporation took over the assets of *B* Corporation in exchange for stock.⁷³ The purchase of *B* stock by *A* would leave unimpaired the rights of each corporation to the relief to which it was entitled before the transaction. The effect would be slight so far as concerns the mechanics of the excess profits tax of *A*. The dividends of *B* to *A* would not be considered excess profits net income.⁷⁴ On the other hand, if the stock were purchased from *A*'s surplus, there would be a capital reduction and consequent diminution of *A*'s excess profits credit because the stock of *B* would constitute an inadmissible asset.⁷⁵ Similarly, if the stock were purchased with borrowed capital, the credit for borrowed capital which *A* would receive would be counterbalanced by the deduction of the value of the stock as an inadmissible asset.⁷⁶

Purchase of the stock of *B* raises a question concerning tax saving devices which found favor with some taxpayers under the excess profits tax in effect during World War II. Under the statute, some taxpayers thought it advantageous to purchase stock in a corporation which had either high base period earnings or historical invested capital⁷⁷ credit with current low earnings, or a high excess profits tax carry over credit.⁷⁸ Thereafter the acquiring corporation with high profits would channel a portion of its enterprises (and consequent profits) through the acquired corporation so that the profits of the latter would be offset by its previous high earnings record or excess profits credit carry over. The same device would become important for carry over and carry back purposes under the standard corporation income tax. The existence of Sections 45, 129 and the business purpose rule make it doubtful whether tax avoidance so patent could currently succeed.⁷⁹

The benefits of *B* stock purchase by *A* are not unlimited. For example, the possibility of juggling financial structures so as to secure advantages

⁷² Under the *Court Holding Co.* rule. See notes 5 and 6 *supra*.

⁷³ See notes 22 to 59 *supra* and text.

⁷⁴ § 433(a)(1).

⁷⁵ § 440. The excess profits tax credit would be reduced for invested capital purposes, § 438, and there would likewise be a net capital reduction for base earnings, § 435(g).

⁷⁶ This result also is reached under computations based on invested capital, § 438, and the base earnings method, § 435(g).

⁷⁷ Under § 458.

⁷⁸ Available under § 432 of the current act.

⁷⁹ Section 129 apparently was intended to control such a case. See note 41 *supra*. Section 45 gives the Commissioner authority to allocate deductions and allowances in cases where two or more organizations have a common control and such allocation is necessary to prevent evasion of taxes. The latter section is discussed incidentally in *Rice, The Sansome-Phipps Rule*, 5 *TAX L. REV.* 523, 540, 541 (1950).

of loans from *A* to *B* following the acquisition of *B*'s stock are severely restricted. To the extent that *A* makes loans to a "controlled group" (which is defined to include *B* Corporation here),⁸⁰ *A* Corporation must deduct 75% of the amount of its loan from its equity capital as an inadmissible asset. Thus, *A* Corporation is penalized to the extent that *B* Corporation gets a benefit from such a loan.⁸¹

*Purchase of the Stock or Assets of B Corporation
by the Stockholders of A Corporation*

As an alternative to the purchase of the stock of *B* by *A* Corporation, it may be thought advisable for *A*'s stockholders to purchase the stock rather than *A* Corporation. While the possibility of this procedure is not remote in the case of two closely held corporations, no substantial tax advantages would appear to accrue therefrom. There would, of course, be no merger of the respective base period earnings records of the companies; nor could there be a consolidation of their assets for purposes of computing an excess profits credit based on invested capital. Neither would it be possible for *A* Corporation to obtain the net capital addition under Section 435 (g) which might accrue if *A* Corporation gave its assets in exchange for *B*'s stock.

Except for Sections 45, 129 and the business purpose rule, it might, of course, be possible for stockholders to channel profitable enterprises from the original corporation with a low excess profits tax credit to a second corporation with a high credit. Stockholders sufficiently misguided to take a chance on this device may, however, accomplish the result as well by causing *A* to acquire *B*'s stock. This is somewhat more feasible, since it reduces possible dissatisfaction of minority stockholders in channelling profits from *A* to *B*.

On the other hand, should the stockholders of *A* Corporation wish to purchase the assets of *B* Corporation and assign those assets to a new corporation (*C*), the latter would be classified as a new corporation under Section 445 and would be entitled to the industry rate of return.⁸² In the event that *B* Corporation had an unsatisfactory base earning period and no possibility of relief this procedure might minimize taxes to the extent that the excess profits credit under industry rates of return exceeded the credit otherwise obtainable by *B*. Some advantage to *A* stockholders would accrue, since *C* Corporation would obtain a new basis for *B*'s assets, based on the purchase price.

Creation of a New Corporation

Some changes in excess profits tax consequences follow if *A* and *B* consolidate by assigning their assets to *C* Corporation (created for this purpose) in lieu of an exchange of *B*'s assets for *A*'s stock. *C* Corporation is

⁸⁰ § 435(g) (6).

⁸¹ § 435(g) (4) (D), (E); 435(g) (6).

⁸² While § 445(g) sharply limits the eligibility of reorganized corporations for treatment thereunder as "new corporations" the limitations of the section do not include this procedure. Purchase of the assets would represent a taxable transaction so far as concerns the profit or loss of *B* corporation under § 22(a).

not, simply by reason of being a "new" corporation, eligible for an excess profits credit based on industry rates of return under Section 445.⁸³ Loans to and from other corporations which are controlled by the majority stockholders of *C* are subject to restrictive conditions already described.⁸⁴ However, any unused excess profits tax credit of *A* and *B* carries over to the new corporation.⁸⁵ *C* Corporation certainly may compute its excess profits credit on the basis of its invested capital under Section 436. It is at least dubious whether it can claim a net capital addition under Section 435 (g); since *C* is a new corporation, there is nothing to which an increase in net capital may be added. The remaining alternative of *C* Corporation is to use the combined base period earnings of *A* and *B*. Assuming that the creation of *C* takes place under authority of a statute, combination of the base period earnings is clearly authorized.⁸⁶ In such a case, the new capital credit and capital additions during the base period of *A* and *B* would be consolidated for purposes of Section 435 (f) and (g).⁸⁷

Relief based on the growth formula (Section 435(e)) is available to *C*, notwithstanding that it is a new corporation, if *A* and *B* were eligible for such relief before the transaction.⁸⁸ If either was ineligible and the transaction took place before July 1, 1950, no relief is available.⁸⁹ If the transaction took place thereafter, the growth formula is available to the base earnings of either corporation previously entitled to relief.⁹⁰ If *C* Corporation obtains only part of the assets of one of the constituents, however, and after the transaction *C* would otherwise be able to comply with the requirements of Section 435(e), failure of *A* or *B* to qualify prior to the transaction would not bar relief.⁹¹

Relief based on industry rates of return is available to *C* Corporation where both *A* and *B* were eligible under one of the relief sections: Sections 442(d), 443, 444, 445, or 446.⁹²

Where *C* Corporation is created, and *A* and *B* transfer only a part of their assets in exchange for its stock, *C* Corporation takes a percentage of the base periods of *A* and *B* equal to that which the value of the assets transferred by them bears to their total assets.⁹³

The problems of consolidation which are here discussed do not differ substantially from mergers. One basic problem is identical: can the benefits

⁸³ §§ 445(g), 462(g) (3).

⁸⁴ See notes 80 and 81 *supra* and text.

⁸⁵ In a merger, the unused excess profits tax credit of a component for years preceding the merger carries over to the resulting corporation. *Stanton Brewery v. Commissioner*, 176 F.2d 573 (2d Cir. 1949).

⁸⁶ §§ 461(a) (4); 462(a), (b).

⁸⁷ §§ 463, 464.

⁸⁸ § 462(c) (1) (A); Senate Report, p. 39.

⁸⁹ § 462(c) (1) (B).

⁹⁰ *Ibid.*

⁹¹ § 462(c) (2).

⁹² This result is stated with relative clarity in § 462(e) to (i), in which the problem of the resulting corporation is specifically considered respecting relief under §§ 443 through 446. The subject is not specifically considered in § 462(d), dealing with abnormalities in base period income, but there is no reason to expect a different result.

⁹³ §§ 462(i), 462(g) (2) (B).

of Part II be obtained as well by the consolidated corporation (*C*) whether it issues the stock to *A* and *B* or to their stockholders? It has already been stated that in the case of mergers no difference in result is anticipated.⁹⁴ Upon the same principles, no difference is foreseen in the case of consolidations.

SPLIT UPS AND SPLIT OFFS

Some tax advantages are obtainable in cases where *A* Corporation splits up, assigning its assets to *X* and *Y* corporations, which in turn issue their stock to *A*. The transaction is tax free as to *A* Corporation.⁹⁵ If, after the exchange, *X* and *Y* established an annual income below \$25,000 for excess profits tax purposes, the advantages are obvious. Not only is the excess profits tax eliminated, but normal corporate income is taxed at lower rates. Also if *A* used the invested capital method and had assets of \$6,000,000 (for example) its credit would be computed at 10%; but *X* and *Y*, with assets of \$3,000,000 each could obtain credit at 12%.⁹⁶ Assuming that either or both resulting corporations have income in excess of \$25,000, it will have the usual alternatives with respect to computing an excess profits tax credit. It may use the invested capital credit, valuing the assets received at the adjusted basis of such assets.⁹⁷ The basis of *X* and *Y* will be the same as that of *A*, under Section 113(a)(6), the assets having been received in a tax free transaction. Hence, their invested capital credit will be limited in the likely event that the assets have been depreciated for tax purposes during ownership by *A* beyond their actual loss in value. *X* and *Y* corporations are not "new corporations" so as to be entitled to compute their base credit on the industry rate of return generally authorized under Section 445, since the basis for their properties is determined by reference to basis in the hands of *A*.⁹⁸ They are, however, entitled to compute their respective base period earnings on an allocated basis with reference to the earnings of *A*;⁹⁹ indeed, the House and Senate reports on the excess profits tax act specifically emphasize that such a transaction is within the scope of Part II.¹⁰⁰ In such an event, they would allocate the new capital credit and base period capital increases which *A* held under Section 435(f) and (g).¹⁰¹ *X* and *Y* would likewise be entitled to the growth alternative,¹⁰² and to any relief under Sections 442 through 446 for which the original corporation had been

⁹⁴ See notes 70, 71 *supra* and text.

⁹⁵ § 112(b)(4). It should be noted incidentally that in the case where *A* transfers all of its assets and later recommences business it is entitled to be treated as a new corporation. The same is true of any corporation transferring all its assets. § 461(d); House Report, p. 65.

⁹⁶ § 437(a).

⁹⁷ § 437(c).

⁹⁸ Section 445(g)(1) provides that such corporations are ineligible for relief thereunder "except under the circumstances and subject to the limitations provided in section 462(g)." That section authorizes no relief in the usual case; however, where *A* had begun business subsequent to the beginning of its base period, *X* and *Y* would have been entitled to industry rates of return on an allocated basis under § 462(g)(2)(B).

⁹⁹ § 461(a)(1)(E).

¹⁰⁰ House Report, p. 29.

¹⁰¹ §§ 463, 464. Senate Report, pp. 37, 39.

¹⁰² § 462(c)(2). Emphasis on the availability of this relief is found in the legislative history of the act. House Report, pp. 30, 68; Senate Report, p. 39.

eligible, based on allocation of the constructive earnings in sums measured by the percentage of total assets transferred to the acquiring corporation. Section 462(d), (e), (f) and (g) seems reasonably explicit in this respect.¹⁰³

All of the foregoing is equally applicable to a case in which *A* Corporation splits off a portion of its assets and assigns them to *X* Corporation in exchange for *X* stock. The effect of such a transaction on the original corporation has been noted elsewhere.¹⁰⁴

The foregoing discussion concerns cases where a split up or split off is accomplished through an exchange of the stock of *X* and *Y* for *A*'s assets in a reorganization under Sections 112(g) and 112(b)(4). In such a case, of course, dividends would be paid by *X* and *Y* to *A* and thence to its stockholders. *A* would get only an 85% dividends received credit under Section 26 so that 15% of the earnings of *X* and *Y* would be taxed twice before receipt by *A*'s stockholders. To avoid this result, it might be thought advisable to transfer assets to *B* in exchange for the issuance of *B* stock directly to *A*'s stockholders under Section 112(b)(3). The effect of such a device has hitherto been considered with respect to mergers and consolidations. In the case of a split off, it is by no means clear that such a distribution is tax free: it might be considered to be a partial liquidation of *A* or a distribution taxable in full to *A*'s stockholders under Section 115(g).

In any event the excess profits tax consequences of such a device are likely to be disastrous in the case of both split ups and split offs. *X* and *Y* Corporations are not eligible to use industry rates of return since they are not within the scope of Section 445(g). They may not allocate the actual or constructive base earnings period of *A* Corporation to themselves under Part II of the Act because they do not qualify under Section 461(a)(1)(E); that section includes only cases arising under Section 112(b)(4) and (5) and this transaction arises under Section 112(b)(3). Neither do they qualify under the other definitions of Section 461(a). Presumably they can in no event use the benefits of Section 435(g) since they have no base earnings upon which capital additions can be made. They may, of course, use the invested capital method, but their invested capital will be computed on the adjusted basis of the assets in the hands of *A* Corporation, and that is likely to be low. It is possible that distribution to *A* of the stock of *X* and *Y*, followed by the liquidation of *A* and distribution of *X* and *Y* stock to its stockholders would go unchallenged by the Commissioner. In this event *A*'s stockholders would receive capital gain to the extent that the value of the stock received exceeded their basis for the *A* stock.¹⁰⁵

LIQUIDATION OF AND MERGERS WITH SUBSIDIARIES

Substantial excess profits tax consequences are attendant upon liquidation of a subsidiary by a parent. Indeed, while the corporation income tax consequences are not catastrophic in a tax free liquidation under Section 112(b)(6), (7), (9) or (10), they may well be embarrassing to the extent

¹⁰³ See § 462(d)(1)(B), (e)(2), (f), (g)(2)(B).

¹⁰⁴ See notes 60 to 69 *supra* and text.

¹⁰⁵ § 115(c); U. S. Treas. Reg. 111, § 29.115-5.

that the subsidiary has earnings which are added to those of the parent. Where the parent has no earnings at the time of liquidation, this would transform a subsequent distribution by the parent into a taxable dividend to the extent of the earnings of the subsidiary although it otherwise would have been a non-taxable return of capital.¹⁰⁶ The advantage of liquidation is, of course, that the earnings of the subsidiary no longer have to be channelled through the parent corporation with the resulting double tax on 15% of the dividends.

For purposes of the invested capital credit under the excess profits tax, the assets received by the parent are deemed to have the same basis as the stock which the parent held prior to liquidation, with appropriate adjustment for cash received and liabilities assumed by the parent.¹⁰⁷ This, of course, assumes that the stock was purchased for cash or otherwise has a cost basis.¹⁰⁸ If the property received in the liquidation is subsequently exchanged for other property in a tax free transaction, the stock basis attaches to the property obtained by the parent in the later transaction.¹⁰⁹ In substance, for excess profits tax purposes, the liquidation (although actually tax free) is treated as though tax had been recognized. Some advantage may be gained by the parent in liquidation. The assets of the subsidiary may have been depreciated out, thus diminishing the equity invested capital of the subsidiary. After liquidation (for excess profits tax purposes only) the assets have a basis in the hands of the parent equal to the basis of the parent's stock. This factor is, of course, only one of the many which must be weighed in considering liquidation.¹¹⁰ Where the parent computes its credit on the historical invested capital basis, basis for the assets it received is similarly computed except that certain plus and minus adjustments are made representing the net gain or loss of the subsidiary.¹¹¹

A parent using the excess profits credit based on earnings may also elect to proceed under Section 435(g). Whether it proceeds under the latter section or the invested capital method, the following will result: before liquidation the parent has stock which is considered as an inadmissible asset (Section 440) for purposes of computing capital additions or invested capital; on the other hand, the income from the stock is not included in excess profits net income under Section 433(a) (1) (A). After liquidation, the parent has the assets of the subsidiary, which represent a capital addition under Section 435(g)(3) and Section 437.¹¹² This increases the excess

¹⁰⁶ See notes 14 and 15 *supra* and text.

¹⁰⁷ § 470(a), (b). See also House Report, pp. 31, 72, giving a simplified analysis of the section.

¹⁰⁸ § 470(a).

¹⁰⁹ § 470(a) (2).

¹¹⁰ For example, it seems disadvantageous from an excess profits tax standpoint to liquidate a subsidiary which pays no excess profits tax because its income is less than \$25,000. However, as noted, liquidation removes that portion of corporate income tax which arises from the fact that the parent, before distributing to its stockholders the earnings of the subsidiary, must pay tax on 15% of the total received. § 26.

¹¹¹ See § 472.

¹¹² It seems doubtful that this capital addition becomes effective under § 435 before the beginning of the tax year following the transaction. Under § 435(g)(3)(B), the amount by

profits credit of the parent, an increase which is counterweighed by the circumstance that the income from the assets runs directly to the parent and is included in computing its excess profits net income.

Under Section 461(a)(2) and Section 462 the parent may also add the base period earnings of the liquidated corporation to its own in establishing its excess profits credit. Computation of earnings in such a case is governed by the general provisions of Part II of the Act. Accordingly, the specific rights of the parent are the same as those of a corporation acquiring assets from another in exchange for stock. This subject hitherto has been discussed at length.¹¹³

The foregoing observations have been directed to liquidations. The parent, however, may prefer to absorb the subsidiary through statutory merger rather than liquidation. The same excess profits tax consequences result.¹¹⁴

One problem of general importance arises under Section 462(j)(1) particularly in connection with liquidations of and mergers with subsidiaries. That section deals with cases in which one corporation acquired stock in another after December 31, 1945, and the second corporation later merged with or was liquidated by the first. It is obvious that under these circumstances a double counting of base period earnings could result. For example, the stock of the second corporation might have been acquired in the middle of the base period of the first corporation. In computing the base period for the first corporation, it is reasonable to exclude that portion of its income for the base period years before the acquisition of its stock which is attributable to the stock. It is also reasonable to adjust the amount of the daily capital addition or reduction of the second corporation by the portion thereof attributable to the previously acquired stock.¹¹⁵ Since the problems here arising are complex, the Commissioner is authorized to adopt regulations respecting the manner in which these adjustments are to be made. A similar provision was incorporated in Section 742(f)(1) of the excess profits tax effective during World War II. Neither of the provisions is clear on its face, and so far as the statutory language is concerned, the Commissioner appears to have been given a blank check.

Regulations with respect to Part II of the Act have not yet been adopted. The regulations adopted during World War II with respect to Section 742(f)(1) of the earlier Act were not entirely clear,¹¹⁶ but under

which equity capital at the beginning of the current tax year exceeds that of the taxpayers' first tax year is added to daily capital addition for the current year. Here the substitution of assets (admissible) for stock (inadmissible) would raise equity capital for the preceding year. Indeed, while the statute is not completely clear, it seems likely that the reduction in inadmissible assets for new capital credit purposes will be limited to 75% of the actual dollar reduction. See § 437(g)(2)(B).

Credit for those using the invested capital is likewise restricted. See § 438(c)(2). There is no limitation, however, respecting the reduction of inadmissibles.

¹¹³ See notes 22 to 58 *supra* and text.

¹¹⁴ As to use of the base period earnings credit of the subsidiary merged, see § 461(a)(1), especially § 461(a)(1)(C), and § 461(a)(3). As to invested capital credit, see § 470(c). See, also, as to adjustment for historical invested capital purposes, § 472(f).

¹¹⁵ The example is in substance the one given in the House Report, p. 70.

¹¹⁶ U. S. Treas. Reg. 112, § 35.742-3(b).

literal construction might have been applied to many cases where there was in fact no duplication. Illustrations of possible unfairness under those regulations could be multiplied, and have been the subject of critical and pointed comment.¹¹⁷ While Section 462(j)(1) does not differ substantially from that of the old act, the legislative history giving substance to this section is explicit. The House Report emphasized that:

"In order to prevent double counting of base period earnings the Secretary is authorized to issue regulations . . ."¹¹⁸

and that:

"Section 462(f)(1) is designed to prevent improper duplications of base period income and capital additions and reductions in cases in which, prior to the transaction which constitutes a corporation an acquiring corporation for purposes of part II and subsequent to December 31, 1945 (whether or not during its base period), such corporation uses its assets to acquire some or all of the stock of the corporation which becomes the component corporation of such acquiring corporation The specific situations presented are complex. Both the manner in which the excess profits net income of the acquiring corporation is to be reduced and the transferred capital addition and reduction adjusted, and the amounts of such reduction and adjustment, are, therefore, to be determined in accordance with regulations prescribed by the Secretary. The Secretary is authorized to prescribe in such regulations the specific situations in which specified adjustments under this section are to be made. If the acquisition of such stock by the corporation is in exchange solely for its own stock, no eliminations or adjustments are necessary, and accordingly section 462(f)(1) is made inapplicable. In case the acquisition is in exchange partly for its own stock and partly for other property, section 462(f)(1) is applicable only to the part of the acquisition attributable to such other property. There are not included in the operation of this provision cases in which the taxpayer acquires stock which has in the hands of the taxpayer a basis determined by reference to the basis of the stock previously acquired by the issuance of the taxpayer's own stock."¹¹⁹

The Senate Report was even clearer. It was there said that:

"In order to prevent double counting of base period earnings experience in applying the recomputation rules provided by part II, the Secretary is authorized to issue regulations providing for reduction of the average base period net income of the taxpayer and adjustments of transferred capital additions and reductions to the extent necessary in cases where, in general, the taxpayer acquired stock in a component corporation for other than its own stock. This provision is carried over from the World War II law and serves to prevent a taxpayer using assets which have had a base period earnings experience in its hands from purchasing stock of a corporation holding other assets which have similarly had a base period earnings experience and subsequently acquiring that latter experience by reason of a

¹¹⁷ Chapman and Bryson, *Corporate Readjustments and the Excess Profits Credit*, 10 LAW AND CONTEMP. PROB. 62, 91-96 (1943).

¹¹⁸ P. 31.

¹¹⁹ P. 70. Section 462(f)(1) was later renumbered and is the current Section 462(j)(1).

part II transaction. The situations where the possibility of double counting may arise are complex. Certain cases have been brought to the attention of your committee where, despite the complexity of the facts, it would appear that double counting was not involved. In view of the difficulty of this question, however, the matter can only be determined in accordance with regulations."¹²⁰

Such emphasis on the purpose of the section is not general in the legislative history of Part II, and impels the conclusion that Congress intended to insure that the regulations of the Commissioner did not require "adjustments" in cases where no duplication of assets existed. This conclusion need not be based alone on the emphasis directed toward duplication of assets. The explanation in the House Report respecting specific cases where no adjustment is required is equally informative. And the observation in the Senate Report that certain cases were brought to the attention of the committee where double counting was not involved partakes of the nature of a warning to the Commissioner that double counting is essential to sustain his rule making power in providing for adjustments. Entirely apart from the statutory basis for regulations as broad as those in effect under the World War II statute, it may be doubted whether regulations unrelated to double counting would not be so whimsical and arbitrary as to deny the offended taxpayer equal protection of the laws. Under all the circumstances, therefore, it may be anticipated that regulations under Section 462(j)(1) will compel adjustments only where double counting is in fact involved.

RECAPITALIZATIONS

The tax consequences arising from conversion of stock into bonds were carefully analyzed under the excess profits tax in effect during World War II.¹²¹

The device discussed is fairly obvious: if stocks are converted into bonds, the corporation may deduct the interest on the bonds as an ordinary and necessary expense for corporate income taxes. Payment of dividends on stock would not, of course, have afforded such a deduction. So far as excess profits tax is concerned, such a transaction may or may not be helpful. The actual cash invested in the corporation is not changed by the transaction. The statute is not clear, but presumably the value of the stock contribution will be deducted from invested capital under Section 435(g), and the value of the bonds substituted for it as borrowed capital. Since borrowed capital is included at only 75% of the total, there will be a corresponding reduction of invested capital which will be compensated in part by the provisions of Section 433(a)(1)(N) which permit a deduction from excess profits tax net income of 25% of the interest paid. What happens when stock worth \$200 is issued for bonds worth \$100 is another question; if the taxpayer uses an excess profits credit based on historical invested capital, presumably the transaction would be immaterial as to its base period

¹²⁰ Pp. 39, 40.

¹²¹ Lasser, *supra* note 40. See also, on the general problem, his *Check List to Find the Effect of the Excess Profits Tax upon Reorganization*, 80 JOUR. OF ACC'Y. 669 (1945).

income thereunder, although it would result in a decrease in its daily capital under Section 438. Where the corporation computes its credit on average earnings, there might well be a net capital reduction which would adversely affect its excess profits credit under Section 435(a)(1).

Any consideration respecting the desirability of recapitalization must be made in the light of *Bazley v. Commissioner*.¹²² In that case a corporation which had substantial earnings issued bonds to stockholders in connection with a reorganization which was claimed to be tax free under Section 112(b)(3) and (g). The Supreme Court, in a sweeping decision, held that the issuance of the bonds really represented a taxable dividend since there was no "reorganization" in good faith under Section 112(g). The exact scope of the decision is unclear since it was limited to its own facts, and the philosophy behind it may mean much or little so far as excess profits tax liability is concerned. But with corporate income tax rates at 47% few corporations with undistributed earnings are likely to be adventurous enough to recapitalize except where it is clear that the net result will not be a distribution of cash earnings. This is particularly true since the *Bedford*¹²³ decision, which apparently holds that any cash distributed in connection with a recapitalization "has the effect of a distribution of a taxable dividend" within Section 112(c)(2).

CONCLUSION

The dominant purpose of sections 438, 435(g) and Parts II and III of the Act is manifest: hardship in corporate reorganizations is to be alleviated by extending options under which the taxpayer may compute its excess profits credit. The obscurity and complexity of these provisions is only commensurate with the task of protecting the innocent, precluding tax evasion, and encouraging corporate expansion in what approaches war economy. And whether the problem presented concerns mergers, consolidations, split ups or recapitalization, these inevitable deficiencies do not preclude careful counsel from measuring in advance the tax effects of corporate reorganizations.

¹²² *Bazley v. Commissioner*, 331 U.S. 737 (1947).

¹²³ *Commissioner v. Bedford*, 325 U.S. 283 (1945). See Darrell, *The Scope of Commissioner v. Bedford's Estate*, 24 TAXES 266 (1946) and Notes, 45 COL. L. REV. 799 (1945), 1 TAX L. REV. 111 (1945).