PAULSEN v. COMMISSIONER, 105 S. Ct. 627 (1985):
EXAMINATION OF THE CONTINUITY OF INTEREST
DOCTRINE IN THE TAX-FREE REORGANIZATION OF
A STOCK SAVINGS AND LOAN ASSOCIATION INTO A
MUTUAL SAVINGS AND LOAN ASSOCIATION

INTRODUCTION

Savings and loan companies across the United States have suffered a great deal due to the economy in recent years. A record of 252 savings and loan associations failed due to high interest rates in 1982.1 During 1983 and 1984, failures of federally insured savings institutions totaled 142.2 To alleviate the financial pains, many financial institutions have consolidated.3 By consolidating, the savings and loan associations pool their resources in an attempt to withstand better the pressures of the economy.4

The Internal Revenue Code ("Code") provides a means to achieve a tax-free corporate reorganization.5 The Code defines the term "reorganization" in a particular way to include corporate mergers and consolidations.6 The combination of Code sections 354 and 368 provides the flexibility necessary in today's economy.7 However,
the continuity of interest doctrine limits the application of the Code sections. Created by the courts, the doctrine ensures that the tax-free provisions are applied to true corporate reorganizations and not to transactions which essentially constitute sales.

The recent United States Supreme Court decision in Paulsen v. Commissioner may have a significant effect on the financial success of today's savings and loan associations. Affirming the Ninth Circuit's decision, the Supreme Court held that the Paulsens' reorganization of their stock savings and loan association was a taxable transfer. The Court determined that the Paulsens did not maintain a continuity of interest between what they had held previously in the stock association and what they acquired in the mutual association.

The Court's holding was contrary to the decisions of the circuit courts of appeals, other than the Ninth Circuit, and the Tax Court.

First, this Note briefly summarizes the operation of the tax-free

(A) a statutory merger or consolidation;
(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or part of the voting stock of a corporation which is in control of the acquiring corporation), of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);
(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded....

Section 368(a)(1)(A) provides the most flexible acquisition type of reorganization as it imposes fewer restrictions on the types of consideration which may be exchanged. See Vrooman, supra note 7, at A-2 (pointing out that in Type A reorganizations, unlike Types B and C, the consideration may consist of securities, non-voting stock, or other types of property, including cash securities).

9. Id. at 659-60. The doctrine may be viewed from two perspectives. See B. Britt-Ker & J. Eustice, supra note 5, ¶ 14.11, at 14-17 to 14-18. On the one hand, the corporate interest focuses on the continuation of business in at least a modified form. Id. at 14-18. On the other hand, the shareholders' interest focuses on the extent of the continuation of their ownership following reorganization. Id. The continuity of interest doctrine, as applied to the shareholders' interest received in an allegedly tax-free reorganization, is the concern of this Note.
11. See note 247 and accompanying text infra.
13. Id. at 632.
14. Id.
15. See notes 147-78, 222-24 and accompanying text infra. See also Vrooman, supra note 7, at A-13.
reorganization provisions of the Code. Second, this Note explores the development of the continuity of interest doctrine, as a judicial policy and its role in early court decisions and later revenue rulings. Third, the focus of this Note turns to the application of the continuity of interest doctrine in the context of a reorganization into a mutual savings and loan association, particularly with respect to the peculiar nature of the consideration exchanged. Fourth, this Note examines the application of the doctrine in Paulsen and explores alternatives to the doctrine. In conclusion, this Note examines a congressional proposal featuring an election mechanism which simplifies the reorganization statutes, suggesting the enactment of the legislation to ensure the protection of business growth.

BACKGROUND

The Internal Revenue Code requires the recognition of gains and losses resulting from the disposition of property unless "otherwise provided." Thus, a taxpayer will recognize gain or loss when he sells or exchanges his business, unless he can qualify for an exception. Code sections 354 and 368 combine to provide such an exception in the context of corporate reorganizations.

In particular, section 354(a)(1) provides in pertinent part:

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are exchanged.

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16. See notes 21-33 and accompanying text infra.
17. See notes 34-108 and accompanying text infra.
18. See notes 109-95 and accompanying text infra.
19. See notes 196-297 and accompanying text infra.
20. See notes 297-320 and accompanying text infra.
(a) Computation of Gain or Loss—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
(b) Amount Realized—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—
(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
(2) there shall be taken into account any amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.
(c) Recognition of Gain or Loss—Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.
22. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.01, at 14-3 to 14-4.
23. Id.
solely for stock or securities in such corporation or in another corporation a party to the reorganization.24

Simply put, the taxpayer does not recognize a gain or loss upon a qualifying corporate reorganization.25

Section 368 defines the term "reorganization"26 by providing seven different types of reorganizations, commonly referred to as "Type A" to "Type G."27 The continuity of interest doctrine primarily relates to the Type A ("statutory merger or consolidation"), Type B ("stock for stock"), and Type C ("stock for assets") reorganizations,28 due to their acquisitive nature.29 The Code distinguishes the Type A reorganization from the other types, in that subsection 368(a)(1)(A) does not impose any restrictions on the kinds of consideration which a taxpayer may receive.30 In contrast, Code subsections 368(a)(1)(B) and (C) provide the particular types of consideration required for the existence of continuity of interest in Types B and C reorganizations.31 Viewed in this light, the flexibility

26. See note 7 supra. This definitional section becomes operative only when the term "reorganization" is used in other provisions. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.02, at 14-9.
29. D. KAHN & P. GANN, supra note 27, at 702. Type A and Type C are used to combine assets of two or more corporations, while Type B provides a method to acquire a subsidiary. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.02, at 14-9.
30. See note 7 supra. Although an exchange of money and securities allowed in a Type A reorganization may constitute boot, this will not necessarily disqualify the transaction as a Type A reorganization. B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.12, at 14-32. For a discussion of "boot," see Kyser, The Long and Winding Road: Characterization of Boot Under Section 356(a)(2), 39 TAX L. REV. 297 (1984). An example of a Type A reorganization is as follows:

In a merger, Corporation X transfers all of its assets to Corporation Y which, by operation of law, assumes all Corporation X's liabilities. The shareholders of Corporation X receive from Corporation Y stock of Corporation Y and, possibly, in addition, securities of Corporation Y and/or other property (including cash) in exchange for other Corporation X stock. In a consolidation, Corporation X and Corporation Y transfer all of their assets to newly created Corporation Z, which, by operation of law, assumes all of the liabilities of Corporations X and Y. The shareholders of the predecessor corporations exchange their stock in Corporations X and Y for stock of Corporation Z and possibly securities or other property.

Vrooman, supra note 7, at A-1.
31. I.R.C. § 368(a)(1)(B)-(C) (1985). A Type B reorganization occurs when "stock of the acquired corporation is obtained in exchange solely for the acquiring corporation's voting stock, or voting stock of a corporation controlling the acquiring corporation, provided the acquiring corporation has 'control' of the acquired corporation immediately after the exchange." Vrooman, Corporate Acquisitions—(B) Reorganizations, TAX MGMT. (BNA) No. 78-3d, at A-1 (1979). This type of reorganization involves only the acquiring corporation and the shareholders of the acquired corporation, not the acquired corporation itself. Id. In contrast, the Type C reorganization occurs
of the Type A reorganization allows for more creative tax planning, as tax planners may attain the requisite continuity of interest through use of various types of consideration, thereby allowing adaptation to the current market. This Note focuses primarily on the Type A reorganization because of its special relationship to the continuity of interest doctrine.

Continuity Of Interest Doctrine

Early Statutory Provisions: Although the continuity of interest doctrine is a judicial effort to ensure the proper application of the reorganization provisions, congressional statutes were the origin of the doctrine's development. The Code did not provide for tax-free reorganizations prior to 1918. However, in a series of three steps taken from 1918 to 1924, Congress laid the foundation for tax-free reorganizations. First, section 202(b) of the Revenue Act of 1918 allowed the taxpayer not to recognize a gain or loss when he received stock or securities in exchange for the same “in connection with the reorganization, merger or consolidation of a corporation.” Second, the Revenue Act of 1921 first defined the term “reorganization,” as used in the earlier act. Third, in the Revenue Act of 1924, Congress explained:

when “the assets of the . . . [acquired] corporation become part of the assets of the acquiring corporation and the acquiring corporation's stock is transferred to the shareholders of the acquired corporation, either directly or by issuance of stock to the [acquired] corporation, which then liquidates.” Vrooman, Corporate Acquisistion — (C) Reorganizations, Tax MGMT. (BNA) No. 79-3d, at A-1 (1982). For a detailed discussion of the statutory requirements, see B. Bittker & J. Eustice, supra note 5, ¶ 14.13-14.14, at 14-37 to 14-59.

32. Vrooman, supra note 7, at A-2.
33. Cf. Turner, Continuity of Interest—Its Application to Shareholders of the Acquiring Corporation, 64 Calif. L. Rev. 902, 915 (1976) (discussing how Congress' awareness of the necessity of allowing acquisitions to occur without excessive consequential tax burdens mandated a flexible approach to reorganizations “to meet the economic challenges of a changing world order”).
34. See B. Bittker & J. Eustice, supra note 5, ¶ 14.11, at 14-17.
37. Turner, supra note 33, at 911.
39. Turner, supra note 33, at 911. Congress defined the term “reorganization” as follows:

The word “reorganization” . . . 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) . . .
tended the definition of "reorganization" to include transfers of all or part of a corporation's assets to a controlling corporation.\textsuperscript{40}

In enacting these statutes, Congress intended to establish the policy that shareholders should not be taxed when they continue to hold a proprietary interest after a reorganization, and receive neither cash nor other tangible property in the transaction.\textsuperscript{41} In essence, Congress desired to avoid tax structures which hindered business reorganization.\textsuperscript{42} The expressed goal, "to negative the assertion of tax in the case of certain purely paper transactions," as reported by the Senate Finance Committee, illustrates the intent of the 1918 Congress.\textsuperscript{43} Moreover, Congress aimed to provide a vehicle for economic growth.\textsuperscript{44}

Thus, Congress saw a need for tax-free reorganizations.\textsuperscript{45} In its legislative hearings,\textsuperscript{46} Congress identified the types of transactions it sought to protect.\textsuperscript{47} However, Congress did not precisely define the requirements for a reorganization sufficient to qualify for tax-free status under the statutes.\textsuperscript{48} This legislative shortcoming spurred the development of the continuity of interest doctrine in the judicial arena.\textsuperscript{49}

Judicial Creation of the Doctrine: A court first recognized the continuity of interest doctrine in Cortland Specialty Co. \textit{v. Commissioner}.\textsuperscript{50} In this case, the acquired corporation transferred substantially all of its assets for cash and promissory notes from the

\begin{footnotes}
\footnotetext[40]{Revenue Act of 1921, ch. 136, § 202(c)(2), 42 Stat. 27, 230 (1921).}
\footnotetext[41]{Revenue Act of 1924, ch. 234, § 203(h)(1)(B), 43 Stat. 253, 257 (1924). Congress included within the term "reorganization" the following provision:

[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 stockholders or both are in control of the corporation to which the assets are transferred. . . .

\textit{Id}. This definition remained substantially the same until 1934, when Congress made a major change in the statutes. \textit{Faber, Continuity of Interest and Business Enterprise: Is It Time to Bury Some Sacred Cows?}, 34 TAX LAW. 239, 244 (1981). The elimination of the parenthetical clause regarding mergers or consolidations from the 1921 Act's language resulted in a statute similar to today's provisions. \textit{See note 39 supra. See also Revenue Act of 1934, ch. 277, § 112(g)(1), 48 Stat. 680, 705 (1934).}}
\footnotetext[42]{\textit{Turnier}, supra note 33, at 912.}
\footnotetext[43]{\textit{Id}.}
\footnotetext[44]{\textit{S. REP. No. 617, 65th Cong., 3d Sess. 5 (1918).}}
\footnotetext[45]{\textit{Turnier}, supra note 33, at 913. The remarks of the Senate debate indicate that Congress was directing the reorganization of business to promote economic growth, whereby the taxpayer substitutes his intangible investment in one corporation for the same type of interest in another. \textit{Id}.}
\footnotetext[46]{\textit{Id}.}
\footnotetext[47]{\textit{See S. REP. No. 398, 68th Cong., 1st Sess. 17-18 (1924); S. REP. No. 617, 65th Cong., 3d Sess. 4-6 (1918).}}
\footnotetext[48]{\textit{Turnier}, supra note 33, at 910-16.}
\footnotetext[49]{\textit{Faber}, supra note 40, at 242.}
\footnotetext[50]{\textit{Id}.}
\footnotetext[51]{60 F.2d 937, 940 (2d Cir.), \textit{cert. denied}, 288 U.S. 599 (1932).}
\end{footnotes}
acquiring corporation.\textsuperscript{51} The court held that the transfer was not a tax-free reorganization,\textsuperscript{52} indicating that section 203 of the Revenue Act of 1926\textsuperscript{53} provided tax relief for profitable business transactions where merely a change in corporate form occurred.\textsuperscript{54} In a tax-free transaction, a taxpayer does not realize an actual gain from the exchange of properties.\textsuperscript{55} Primarily, the court noted that the reorganization statute mandated the continuation of a stockholder interest.\textsuperscript{56} In making its decision, the court, characterizing the promissory note as cash, focused on the nature of the consideration received and ruled that the transaction failed to meet the legislative requirement.\textsuperscript{57}

The Supreme Court cited Cortland with approval in Pinellas Ice & Cold Storage Co. v. Commissioner.\textsuperscript{58} Invoking the continuity of interest doctrine,\textsuperscript{59} the Court held that the transfer of cash and short-term notes for assets of the acquired corporation was a sale, not a tax-free reorganization under section 203.\textsuperscript{60} The Court noted that the statutory provisions of section 203 allowed for a more flexible tax-free transaction.\textsuperscript{61} However, the Court stated that, to be within the exemption, "the seller must acquire an interest in the affairs of the purchasing company more definite than that incident to ownership of its short-term purchase-money notes."\textsuperscript{62} In addition, the Court reasoned that the short-term notes were not securities within the language of section 203.\textsuperscript{63} Rather, the short-term notes were the equivalent of cash, and therefore, the taxpayer should have recognized taxable gain.\textsuperscript{64} Thus, this case essentially established that the

\textsuperscript{51} Id. at 938. The assets in the transaction included leases, real property, merchantable petroleum products, and physical equipment of Cortland. The consideration included cash totalling $53,070 and promissory notes totalling $159,750. The promissory notes matured from 2 to 14 months after closing. Id.

\textsuperscript{52} Id. at 938, 940.

\textsuperscript{53} Revenue Act of 1926, ch. 27, § 203, 44 Stat. 10, 12 (1926). The relevant provision of this act is identical to § 203 of the Revenue Act of 1924. See note 40 supra.

\textsuperscript{54} Cortland, 60 F.2d at 940.

\textsuperscript{55} Id.

\textsuperscript{56} Id. The court stated that, while the Revenue Act's definition of reorganization was liberal, "[i]t does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its shareholders in order to secure exemption. Reorganization presupposes continuance of business under modified corporate forms." Id.

\textsuperscript{57} Faber, supra note 40, at 243.

\textsuperscript{58} 287 U.S. 462, 470 (1932).

\textsuperscript{59} Id. Suprisingly, the words "continuity of interest" are absent from the opinion. Faber, supra note 40, at 244.

\textsuperscript{60} Pinellas Ice & Cold Storage Co., 287 U.S. at 468-69.

\textsuperscript{61} Id. at 469-70.

\textsuperscript{62} Id. at 470.

\textsuperscript{63} Id.

\textsuperscript{64} Id. at 469. However, this raised the question of the length of time necessary for a note to qualify as a security, which the Court later answered in LeTulle v. Scofield, 308 U.S. 415 (1940). See notes 85-91 and accompanying text infra.
shareholder must obtain some type of equity in the acquiring corporation.\textsuperscript{65}

Three years later, the Supreme Court further refined the continuity of interest doctrine in several decisions handed down on the same day.\textsuperscript{66} The Court’s opinion in \textit{Helvering v. Minnesota Tea Co.}\textsuperscript{67} provides the most comprehensive discussion of the doctrine.\textsuperscript{68} The acquired corporation in \textit{Minnesota Tea Co.} transferred its assets to the acquiring corporation in return for voting trust certificates and cash.\textsuperscript{69} The acquired corporation immediately distributed all of the cash among the stockholders while retaining the certificates.\textsuperscript{70} The Court upheld the lower court’s decision that the transaction satisfied the reorganization requirements of the Revenue Act of 1928.\textsuperscript{71} In so holding, it reasoned that the acquired corporation need not dissolve in order to effectuate a reorganization.\textsuperscript{72} More significantly, the Court expanded the rule set down in \textit{Pinellas}, deciding that the shareholders of the acquired corporation must obtain a “definite and material” interest in the acquiring company, representing a “substantial part of the value of the thing transferred.”\textsuperscript{73} The Court noted that a change in the taxpayer’s relationship to the assets conveyed would not infringe upon the statute.\textsuperscript{74} It did not discuss how the consideration in the case satisfied its requirement that a “definite” interest be transferred.\textsuperscript{75}

In other decisions handed down that day, the Court also focused on the interest received or acquired by shareholders. In \textit{John A. Nelson Co. v. Helvering},\textsuperscript{76} the taxpayers transferred all of their property,

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\textsuperscript{65} \textit{Pinellas Ice & Cold Storage Co.}, 287 U.S. at 470.
\textsuperscript{67} 296 U.S. 378 (1935).
\textsuperscript{68} Id. at 383.
\textsuperscript{69} Id. at 381. The voting trust certificates represented 18,000 shares of the acquiring corporation’s common stock. The amount of cash in the transaction totalled $426,842.52. Id.
\textsuperscript{70} Id.
\textsuperscript{71} Id. at 382-83. The Court classified the transaction as “a bona fide business move,” contrasting it with the transaction in \textit{Gregory v. Helvering}, 293 U.S. 465 (1935), which the Court viewed as a “sham.” \textit{Minnesota Tea Co.}, 296 U.S. at 385. In \textit{Gregory}, the Supreme Court held that the taxpayer’s reorganization of a corporation, created solely to escape taxation of a dividend, was “an elaborate and devious form of conveyance masquerading as a corporate reorganization, and nothing else.” \textit{Gregory}, 293 U.S. at 470.
\textsuperscript{72} \textit{Minnesota Tea Co.}, 293 U.S. at 383.
\textsuperscript{73} Id. at 384-85.
\textsuperscript{74} Id. at 386.
\textsuperscript{75} See Faber, supra note 40, at 248.
\textsuperscript{76} 296 U.S. 374 (1935).
except $100,000, for $2,000,000 cash and all of the non-voting preferred stock in the acquiring corporation.\textsuperscript{77} The Court held that the transfer satisfied the reorganization provision of section 203 and, while doing so, clarified the requirements of the continuity of interest doctrine.\textsuperscript{78} The Court noted that, in a tax-free reorganization, the taxpayer does not necessarily have to participate in the management of the acquiring corporation or possess a controlling interest in that corporation.\textsuperscript{79} In addition, the Court reiterated that the statute does not demand the dissolution of the acquired corporation.\textsuperscript{80}

Similarly, the receipt of stock and mortgage bonds by the taxpayer in Helvering \textit{v. Watts}\textsuperscript{81} was within the terms of the reorganization statute.\textsuperscript{82} Distinguishing the short-term notes received by the taxpayers in \textit{Pinellas}, the Court in \textit{Watts} found the mortgage bonds to be securities,\textsuperscript{83} an allowable form of consideration under the statute.\textsuperscript{84}

The last major Supreme Court decision in the early development of the continuity of interest doctrine was \textit{LeTulle \textit{v. Scofield}}.\textsuperscript{85} In this 1940 decision, the Court concluded that an exchange of land for cash and bonds, payable over an eleven-year period,\textsuperscript{86} did not constitute a tax-free reorganization.\textsuperscript{87} The Court emphasized that a transaction does not sufficiently satisfy the statute by mere literal compliance; rather, the taxpayer must retain a substantial stake in

\textsuperscript{77} Id. at 376. The taxpayer not only retained the $100,000 cash, but also its franchise and continued liability for certain obligations. The acquiring corporation distributed the preferred stock among the stockholders of the acquired corporation. \textit{Id.}

The Court stated:

\begin{quote}
The Commissioner, Board of Tax Appeals and the court all concluded that there was not a reorganization. This, we think, was error. . . . True, the mere acquisition of the assets of one corporation by another does not amount to reorganization within the statutory definition. . . . But where, as here, the seller acquires a definite and substantial interest in the affairs of the purchasing corporation, a wholly different situation arises.
\end{quote}

\textit{Id.}\textsuperscript{78}

\textsuperscript{79} \textit{Id.} at 377.

\textsuperscript{80} \textit{Id.}

\textsuperscript{81} 296 U.S. 387 (1935).

\textsuperscript{82} \textit{Id.} at 388-89.


\textsuperscript{84} \textit{Watts}, 296 U.S. at 388. The Court indicated that the applicable statutory provision was § 203 of the Revenue Act of 1924. \textit{See} note 40 \textit{supra}. This section required that the consideration was an exchange of stock or securities for like kind in order for the reorganization to be non-taxable. \textit{Id.}

\textsuperscript{85} 308 U.S. 415 (1940).

\textsuperscript{86} \textit{Id.} at 416.

\textsuperscript{87} \textit{Id.} at 418, 420.
the acquired corporation.88 Addressing the issue of whether bonds qualify as consideration in a tax-free reorganization, the Court indicated that even a long-term bond was not sufficient.89 Instead, whenever the consideration consists entirely of bonds in combination with cash, the transaction will not qualify for tax-free status.90 The rationale is that the bondholder in such a situation becomes a creditor of the corporation, rather than a holder of a proprietary interest.91

None of the earlier cases specifically dealt with a Type A reorganization, a statutory merger or consolidation.92 A court first applied the continuity of interest doctrine to a Type A reorganization in Roebling v. Commissioner.93 In this case, the sole consideration received by the shareholders of the acquired corporation consisted of a one-hundred year, eight-percent bond in the acquiring corporation, in return for their preferred stock, which yielded a fixed, annual return of eight percent.94 Despite the exchange of seemingly equivalent investments, the Third Circuit viewed the transaction as a sale since the taxpayer received a debt interest instead of an equity interest in the acquiring corporation.95 In applying LeTulle, the court ruled that the receipt of the debt instrument would not satisfy the requisite continuity of interest.96

By the early 1950’s, a number of courts had established the continuity of interest doctrine as applied in Minnesota Tea as a prerequisite to a tax-free reorganization.97 As interpreted in these cases, the

88. Id.
89. Id. at 420.
90. Id. at 420-21.
91. Id. at 421.
92. Faber, supra note 40, at 249. The developmental cases dealt primarily with transactions within the parenthetical clause of the early statutory provision. Id. For the text of the early statutory provision, see note 39 supra.
93. 143 F.2d 810 (3d Cir.), cert. denied, 323 U.S. 773 (1944). The Fifth Circuit Court of Appeals held that the continuity of interest doctrine applied to Type A mergers in Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 333 (5th Cir.), cert. denied, 342 U.S. 860 (1951). This case involved a transaction wherein the stockholders of the acquiring corporation had exercised one of two options. Id. at 333. Some of the stockholders “cashed in” their shares. On the other hand, 59% of the shareholders traded their shares for common stock and mortgage bonds in the acquiring corporation and a lesser amount of cash. The court held that the transaction was not a tax-free statutory merger as the proprietary interest constituted, at most, one percent of the consideration price. Id.
94. Roebling, 143 F.2d at 811.
95. Id. at 814.
96. Id. One commentator asks whether it is logical to apply LeTulle, where the Court rejected a debt instrument as constituting a proprietary interest, to a transaction where a debt instrument is the only consideration received. See D. KAHN & P. GANN, supra note 27, at 730. See also West Side Fed. Sav. & Loan Ass’n v. United States, 494 F.2d 404, 411 (6th Cir. 1974) (receipt of mutual share account, the only possible proprietary interest, satisfied the continuity of interest requirement).
97. See, e.g., Southwest Natural Gas Co. v. Commissioner, 189 F.2d 332, 333 (5th
doctrine consists of two elements. The Fifth Circuit, in *Southwest Natural Gas Co. v. Commissioner*, summarized these two elements of the continuity test as follows:

While no precise formula has been expressed for determining whether there has been retention of the requisite interest, it seems clear that . . . [there must be] a showing: (1) that the transferor corporation or its shareholders retained a substantial proprietary stake in the enterprise represented by a material interest in the affairs of the transferee corporation, and, (2) that such retained interest represents a substantial part of the value of the property transferred.

First, the doctrine requires the retention of a "definite and material" proprietary interest by the shareholders of the acquired corporation. A proprietary interest represented by long-term debt, cash, or short-term notes will not suffice. The courts construe transactions involving these types of consideration as converting the taxpayer's proprietary interest into cash or a credit obligation flowing from the acquiring corporation. Second, the doctrine requires that a portion of the consideration consists of a "continuity preserving" interest. The Supreme Court's test requires that the interest represents a substantial part of the value transferred. However, this second element becomes less clear when considering the varying po-
The nature of the "hybrid" instrument commonly transferred in savings and loan mergers further complicates the analysis required in applying the doctrine. In these cases, not only does a court face the task of determining whether a taxpayer received a "debt" or "equity" interest, but also may face the difficult task of determining whether the equity characteristics outweigh the debt characteristics. The application of the continuity of interest doctrine to savings and loan association mergers by both the Internal Revenue Service and the courts demonstrates the difficult burden which the Court faced in Paulsen.

Service Pronouncements

The Internal Revenue Service ("Service") has recognized qualification under the continuity of interest doctrine as a major prerequisite to a tax-free corporate reorganization. The Service rulings, however, are vague as to the particular elements of the doctrine. Clearly, the acquired corporation's shareholders must retain "some element of continued ownership." The Service pronouncements illustrate this factor in relation to reorganizations of savings and loan associations. In a stock savings and loan association, the guaranty stock represents the requisite equity interest central to qualification under the continuity of interest doctrine. In contrast, the savings or passbook accounts of mutual savings and loan associations represent a "hybrid" instrument. Although the savings accounts represent the sole proprietary interest in a mutual association, the Service hesitates to regard the savings accounts as a satisfactory basis

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107. Id. The hybrid instrument involved in this situation combines characteristics of debt and equity. Id. See also note 120 and accompanying text infra.
108. Faber, supra note 40, at 250.
109. Id.
110. Id.
111. Id.
112. See Rev. Rul. 69-6, 1969-1 C.B. 104, 104. The Service stated that the acquiring corporation must deliver a substantial proprietary interest to the shareholders of the acquired corporation. Id.
113. Guaranty stock is "[a]stock in a savings and loan association... which yields all dividends to the holders after dividends to depositors or savers." BLACK'S LAW DICTIONARY 1270 (5th ed. 1979).
115. See Note, Reorganization Treatment of Acquisitions of Stock Savings and Loan Institutions by Mutual Savings and Loan Associations, 52 FORD. L. REV. 1261, 1288 (1984). Typically, the equity interest includes the right to vote, to receive dividends, and to share in asset distribution upon liquidation, whereas the debt interest includes the right to cash in the share account, and in some cases, to maintain priority over general creditors. Id.
116. Id. at 1271.
for the required continuity of shareholders' interest.\footnote{117}{See generally Chappell, Judicial View That S & L Passbook Accounts Are Not “Stock” Complicates Reorganizations, 44 J. Tax’n 372, 373-74 (1976) (discussing problems associated with applying continuity of interest doctrine to reorganizations of mutual savings and loan associations).}

In 1969, the Service embarked on a wavering course in examining shareholder interests in savings and loan association reorganizations. Revenue Ruling 69-3\footnote{118}{Rev. Rul. 69-3, 1969-1 C.B. 103.} addressed a merger of two federally chartered mutual savings and loan associations.\footnote{119}{Id. at 103.} In the transaction, the acquiring association issued passbook accounts equal to the dollar amount of the shareholder’s account with the acquired association.\footnote{120}{Id.} The Service concluded that the statutory merger of two mutual savings and loan associations qualified as a tax-free reorganization under section 368(a)(1)(A).\footnote{121}{Id.}

To reach this decision, the Service pointed out that members of a mutual savings and loan association have a dual relationship to the association for two reasons.\footnote{122}{Id. at 103.} First, the share account holders possess a proprietary interest in the association due to their status as members; second, a debt interest exists by virtue of the fact that the withdrawable deposits represented by the passbooks are the equivalent of cash.\footnote{123}{Id.} The Service viewed the two types of interests separately, determining that the exchange of proprietary interests carried out in an equity-for-equity transfer, satisfied the continuity of interest requirement.\footnote{124}{Id. See also Chappell, supra note 117, at 372 (substance of transaction is equity-for-equity transfer).}

In Revenue Ruling 69-6,\footnote{125}{Rev. Rul. 69-6, 1969-1 C.B. 104.} the Service examined the acquisition of a state-chartered savings and loan association by a federally chartered mutual savings and loan association.\footnote{126}{Id. at 104.} This ruling involved the same basic transaction as found in Paulsen v. Commissioner, 105 S. Ct. 627 (1985), wherein a federal mutual savings and loan acquired a stock savings and loan. See notes 196-221 and accompanying text infra. See also note 14 and accompanying text supra.\footnote{127}{Rev. Rul. 69-6, 1969-1 C.B. 104, 104.} The ruling reaffirmed the view of a dual relationship of a mutual savings and loan association to its members.\footnote{128}{Id. See also notes 122-24 and accompanying text supra. The Service decided not to sever the passbook account into its separate debt and proprietary interests. Rev. Rul. 69-6, 1969-1 C.B. 104, 104.}
Service ruled that the passbooks did not satisfy either the "solely...for...voting stock" provision in the statutory definition of a Type C reorganization or the continuity of interest requirement for a Type A merger. The Service gave minimal value to the indicia of ownership in the mutual association and instead concentrated on the cash equivalent received in the passbook account.

In Revenue Ruling 69-646, the Service determined that an exchange of savings passbook accounts satisfied the continuity of interest requirement. The Service concluded that no taxable transaction occurred when two building and loan associations reorganized under section 368(a)(1)(A). The passbook accounts transferred represented the sole equity interest in the acquired corporation. In essence, the passbook shareholders of the acquired corporation substituted the cash deposits represented by their accounts for equivalent accounts in the acquiring corporation. Furthermore, the taxpayers received guaranty stock in the acquiring corporation equivalent to their right to a pro rata share in individual profits and reserves upon liquidation. The Service ruled that the latter exchange satisfied the requirement of an equity-for-equity exchange.

The Service has compared the proprietary interest of the tax-

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129. Rev. Rul. 69-6, 1969-1 C.B. 104, 104-05. Type B reorganizations were not addressed, apparently because the factual situation did not meet the statutory prerequisite of a stock-for-stock exchange. See note 31 supra.

130. Rev. Rul. 69-6, 1969-1 C.B. 104, 104. Note the contrast with Revenue Ruling 54-624, 1954-2 C.B. 16. This ruling identified the rights of the account holders of federally chartered mutual savings and loan associations. Id. at 18. These incidents of ownership were identified as follows:

[Participation in the election of a board of directors, ... the right to share in the profits, ... [and] equal distribution of assets, pro rata to the value of their savings accounts, in the event of voluntary or involuntary dissolution or winding up of the association.]

Id. Comparing these rights to the rights of ordinary bank depositors, it was recognized that the mutual account holders held a proprietary interest in the mutual savings and loan association. Id. at 17-18.


132. Id. at 54. The passbooks in the acquired association represented not only the shareholders' savings account balances but also their equity interest, which included the right to vote and the right to share in undivided profits and reserves. Id. at 55.

133. Id.

134. Id.

135. Id. The Service stated: "In no instance will an [acquired association] shareholder receive [an acquiring association] passbook reflecting an account balance greater or less than that appearing in his ... passbook on the date of the exchange."

Id.

136. Id. The Service stated: "[N]or will the fair market value of the guaranty shares ... received by an [acquired association] shareholder be greater or less than his pro rata interest in the undivided profits and reserves ... on the date of the exchange."

Id.

137. Id.
payer before and after the transaction. Generally, the Service will uphold a reorganization as tax free when the taxpayer moves from an essentially liquid equity interest to a more conventional equity interest. However, the continuity of interest requirement will not be satisfied if the taxpayer moves in the opposite direction. This position may be regarded as inconsistent. Revenue Rulings 69-6 and 69-646 seem to contradict each other in that the same instrument, the mutual share account, is regarded as satisfying the continuity of interest in one ruling but not in the other. Yet, in light of the fact that the mutual association share account is more liquid, transactions, involving a taxpayer's receipt of mutual share accounts, should be taxed more readily, since in this situation the Code's definitional provisions for tax-free reorganizations will be more difficult, if not impossible, to meet.

Doctrine's Application to Savings & Loan Associations

The judiciary, like the Service, has applied the continuity of interest doctrine in the context of the savings and loan association mergers. The courts have noted that the hybrid nature of the mutual account presents a dilemma as to the classification of the interest. Despite the debt and equity characteristics of the mutual instrument, courts have held that the mutual account was an equity interest, satisfying the continuity of interest requirement. A judicial opportunity to characterize the interest held in a mutual savings and loan association, following the 1969 Revenue Rulings, arose in the 1971 decision, Everett v. United States. This case involved the transfer of the assets and liabilities of a state-chartered building and loan association to a federal, mutual savings and loan as-

\[138.\] Chappell, supra note 117, at 373.

\[139.\] Id. The liquid type of interest may be represented by withdrawal accounts, whereas the conventional interest would be typically represented by stock certificates. Id. at 373-74.

\[140.\] Id. at 374.

\[141.\] See notes 129 and 132 and accompanying text supra.

\[142.\] See notes 139-40 and accompanying text supra.

\[143.\] See notes 147-195 and accompanying text infra.

\[144.\] See Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974 (Ct. Cl. 1979); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 411 (6th Cir. 1974).

The court ruled that the transaction met the requirements for a tax-free reorganization under section 368(a)(1)(C) of the Code.

The court based its decision on two major points. First, the court reasoned that the mutual share accounts constituted "voting stock." The court pointed out that the share accounts possessed many equity attributes such as voting rights and the sharing in liquidation proceeds. Recognizing that the share accounts had the indicia of both debt and equity, the court, nonetheless, stated that only the quality of the rights associated with the accounts determined the type of interest received. Second, the court held that shareholders of the acquired association retained a sufficient interest in the acquiring association. The exchange of share accounts, representing eighty-three percent of the fair market value of the acquired corporation, for voting stock (share accounts) in the acquiring mutual association satisfied the strict continuity of interest test for a Type C reorganization.

The case which clearly explained the continuity of interest doctrine and which directly contradicts the Paulsen case is Westside Federal Savings & Loan Association v. United States. In this case, Parma Savings and Loan, a state-chartered savings and loan association, merged, pursuant to Ohio statutes, into Westside Savings and Loan, a federally chartered savings and loan association. In the transaction, shareholders of Parma Savings and Loan exchanged $200 par value Parma Savings and Loan stock for Westside Savings and Loan savings accounts. The Sixth Circuit held that a tax-free reorganization occurred within the terms of section 368(a)(1)(A).

The Type C reorganization has a stricter continuity of interest test due to the type of consideration required under the statutory provision. See generally B. BITTKER & J. EUSTICE, supra note 5, ¶ 14.14. See also West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 410 (6th Cir. 1974). In its decision, the Sixth Circuit traced the historical development of the continuity of interest doctrine from its inception in Cortland Specialty Co. v. Commissioner, 60 F.2d 937 (2d Cir. 1932), through the Service's position in its 1969 rul-
Most significant was the court's recognition of the mutual savings account as the only proprietary interest in the federal mutual association.\textsuperscript{159} The court noted the impropriety of concentrating primarily on the mutual shareholders' possessing the rights of a creditor while ignoring the proprietary rights represented by their share accounts.\textsuperscript{160} Instead, the historical development of the continuity of interest doctrine illustrated that the court should focus on the nature of the interest received in the acquiring corporation.\textsuperscript{161} Thus, the court reasoned that it should not determine whether the shareholder of the acquired association received "more or less of a proprietary interest."\textsuperscript{162} Since the analysis of continuity of interest doctrine should not be based on the mixture of debt and equity in a single instrument,\textsuperscript{163} the court concluded that the West Side share accounts received by the shareholders represented a definite and material interest and a substantial part of the consideration received.\textsuperscript{164}

In 1979, the United States Court of Claims took essentially the same position as the Sixth Circuit did in \textit{West Side} when addressing the continuity of interest doctrine in \textit{Capital Savings & Loan Association v. United States}.\textsuperscript{165} The court held that the statutory merger of a stock savings and loan association into a mutual savings and loan association met the doctrine's requirements.\textsuperscript{166} In rejecting the Service's arguments,\textsuperscript{167} the court first pointed out the contradictory position of the Service on the characterization of mutual savings accounts.\textsuperscript{168} In Revenue Ruling 69-3\textsuperscript{169} and Revenue Ruling 78-
the Service found the continuity of interest requirement fulfilled by the taxpayer's receipt of passbook savings accounts with and without voting rights, in each ruling respectively, in mutual savings and loan associations. The court cited other cases where courts had recognized the equity characteristics of the savings accounts of mutual savings and loan associations. The court reasoned, on the basis of this precedent, that the Capital Savings and Loan accounts had "all the indicia of stock," including the right to vote, to receive dividends, and to share proportionately in the assets upon liquidation following the payment of creditors.

The Court of Claims in Capital, following the circuit court decisions in West Side and Everett, held that the hybrid instrument qualified as a proprietary interest. The court pointed out that the mere fact that the Capital Savings and Loan account holders could withdraw their interest on demand should not cloud the characterization of the interest, citing earlier courts which held that the duration of the interest did not control. The court refused to disqualify the new equity interest of the acquired association's shareholders as a proprietary interest.


170. Rev. Rul. 78-286, 1978-2 C.B. 145, 146. While the shareholders did not have voting rights under state law, most other facts in Capital were identical to those in Revenue Ruling 69-3. Id. at 145; Rev. Rul. 69-3, 1969-1 C.B. at 104. The Service ruled that, because only holders of deposits in the mutual savings bank could participate in the distribution of assets upon liquidation, this fact would satisfy the continuity of interest requirement. Rev. Rul. 78-286, 1978-2 C.B. at 146; Rev. Rul. 69-3, 1969-1 C.B. at 103-04.

171. Capital, 607 F.2d at 975.

172. Id. The authorities cited included Wisconsin Bankers Ass'n v. Robertson, 294 F.2d 714 (D.C. Cir.), cert. denied, 368 U.S. 938 (1961), where investment characteristics in savings and loan share accounts, including the right to vote and elect management, distinguished such accounts from deposits in banks. Capital, 607 F.2d at 940. Also discussed was Tcherepnin v. Knight, 389 U.S. 332 (1967). In Tcherepnin, withdrawable savings account holders received dividends in proportion to their amount of investment only when the association made a profit. Id. at 338-39. This result led the Supreme Court to allow investor protection under the Securities Exchange Act of 1934 for the account holders. Id. at 342. See also Fahey v. Mallonee, 332 U.S. 245 (1947); Fidelity Sav. & Loan Ass'n v. Burnet, 65 F.2d 477 (D.C. Cir.), cert. denied, 290 U.S. 652 (1933).

173. Capital, 607 F.2d at 975-76. One set of commentators has described a stock interest as follows:

Ordinarily, a share of "stock" embodies the permanent proprietary ownership or equity interest in a corporation which entitles the holder to (a) share proportionately in the profits of the business; (b) vote on matters affecting the corporate enterprise; and (c) share ratably in the assets of the venture (after payment of debts) on liquidation. . . ."


174. Capital, 607 F.2d at 976.

175. Id. at 977.

proprietary interest, for doing so would imply that the association had no owner.\textsuperscript{177} Thus, the court once again required an analysis of the nature of the interest received.\textsuperscript{178}

In contrast to the other circuits, the Ninth Circuit viewed differently the characteristics of an interest represented by nonstock share accounts in \textit{Home Savings & Loan Association v. United States.}\textsuperscript{179} Home Savings and Loan, a stock savings and loan association,\textsuperscript{180} acquired two other savings and loan associations — the Pasadena Savings and Loan Association and the Savings and Loan Association of Anaheim.\textsuperscript{181} Each of the acquired associations had outstanding guaranty stock.\textsuperscript{182} In addition, Pasadena Savings and Loan's shareholders possessed withdrawable shares, which gave them the right to share in the profits of the association, to elect directors, and to withdraw their investment upon proper notice.\textsuperscript{183} The Anaheim Savings and Loan had issued investment certificates in addition to its guaranty stock.\textsuperscript{184} The investment certificates entitled certificate holders to earn interest on their investment, but the association's bylaws failed to give them a right to vote.\textsuperscript{185} Home Savings and Loan purchased the outstanding stock of each association for cash and exchanged its withdrawable shares for the withdrawable shares and investment certificates of the acquired associations.\textsuperscript{186}

In determining that the transaction was not a tax-free reorganization, the court held that neither the withdrawable shares nor the investment certificates constituted a proprietary interest.\textsuperscript{187} The Ninth Circuit viewed the two types of interests as possessing primarily debt characteristics, focusing upon a holder's ability to realize cash virtually upon demand, a California statute which conferred voting rights on debtors as well as shareholders, and the dividends' close resemblance to interest payments.\textsuperscript{188} While this case involved the receipt of share accounts in an exchange between stock savings and

\textsuperscript{177} \textit{Capital}, 607 F.2d at 976.
\textsuperscript{178} \textit{Id.} at 977.
\textsuperscript{179} 514 F.2d 1199, 1206 (9th Cir.), cert. denied, 423 U.S. 1015 (1975).
\textsuperscript{180} \textit{See Home Sav. & Loan Ass'n}, 514 F.2d at 1203. Guaranty stock and withdrawable share accounts formed the capital structure of Home Savings and Loan. \textit{Id.} A withdrawable share entitled a holder to vote, to receive dividends, and to share in liquidation proceeds. \textit{Id.} at 1203, 1206.
\textsuperscript{181} \textit{Id.} at 1203-04.
\textsuperscript{182} \textit{Id.} at 1202-03.
\textsuperscript{183} \textit{Id.} at 1202.
\textsuperscript{184} \textit{Id.} at 1203.
\textsuperscript{185} \textit{Id.} A California statute stated that certificate holders had voting rights only to the extent that the association's bylaws provided them. \textit{Id.}
\textsuperscript{186} \textit{Id.}
\textsuperscript{187} \textit{Id.} at 1205-06.
\textsuperscript{188} \textit{Id.} at 1206, 1208.
loan associations, the Ninth Circuit reserved comment on the exchange of share accounts when a mutual association would be involved.189

In summary, a majority of the circuit courts addressing the issue had concluded that a taxpayer's receipt of a mutual share account in a reorganization would satisfy the continuity of interest requirement.190 In finding the required continuity of interest, each court focused on the proprietary characteristics of the mutual share account and concluded that the quality of the interest, rather than the label attached to the interest, controlled its determination.191 Moreover, the circuit courts emphasized that the proper inquiry focuses on the receipt of a proprietary interest in the acquiring association, rather than a before and after comparison of the proprietary interest held by members of the acquired association.192 On the other hand, the Ninth Circuit based its decision on the debt characteristics of hybrid savings accounts.193 The court concluded that the instruments did not qualify as proprietary interests.194 The conflict in the courts' and Service's consideration of the proprietary interest established the need for the United States Supreme Court's review.195

FACTS AND HOLDINGS

In Paulsen v. Commissioner,196 the United States Supreme Court addressed the issue of whether the merger of a stock savings and loan association into a mutual savings and loan association quali-

189. Id. at 1208-09. With regard to exchanges involving mutual savings and loan associations, the Ninth Circuit stated:

Moreover, we also recognize that the statutory merger of two associations whose debt and equity are indistinguishable, as perhaps in the case of two mutual savings associations, raises issues different from those before us here. Under such circumstances a spectrum of interests may vanish leaving only one broad and uniform band to depict the only interest that can exist. Assuming that there must exist in all associations a proprietary interest, such broad and uniform interest may well serve that purpose. Its capacity to do so should not be impaired by the fact that it also may constitute debt.

Id.

190. See notes 147-48 and accompanying text supra. See also Rocky Mountain Fed. Sav. & Loan Ass'n v. United States, 473 F. Supp. 779, 781, 783 (D. Wyo. 1979) (merger of a state-chartered, guaranty capital savings and loan into a federally chartered, mutual savings and loan association satisfied the continuity of interest requirement for a Type A reorganization); First Fed. Sav. & Loan Ass'n v. United States, 452 F. Supp. 32, 35-36 (N.D. Ohio 1978) (shareholders of acquired association possessed a continuity of interest, and did not become creditors, in the exchange of stock for savings deposit accounts in the acquiring mutual association).

191. See notes 147-78 and accompanying text supra.

192. Capital, 807 F.2d at 976; Westside, 494 F.2d at 411.

193. See notes 186-88 and accompanying text supra.

194. Id.

195. See Comment, supra note 141, at 201.

fied as a tax-free reorganization under Code sections 354 and 368(a)(1)(A). Specifically, the Court’s opinion examined whether Harold and Marie Paulsen (“Paulsens”) had retained the requisite continuity of interest in the exchange of guaranty stock in a stock association for passbook accounts and time certificates in a mutual association.

Commerce Savings and Loan Association of Tacoma was incorporated and operated under the laws of the State of Washington. As a state-chartered savings and loan association, Commerce Savings and Loan could issue guaranty stock, offer several classes of savings accounts, and make loans. As a member of Commerce Savings and Loan, each guaranty stockholder, savings account holder, and borrower had a right to vote.

Commerce Savings and Loan's bylaws required it to maintain a minimum amount of guaranty stock as fixed and nonwithdrawable capital. State law provided that only guaranty stockholders had a proprietary interest in Commerce Savings and Loan's assets and net earnings were subordinate to creditors' claims. Moreover, dividends on guaranty stock were paid only if certain reserves had accumulated and dividends had been declared and paid on the withdrawable savings account. Thus, with these factors, the guaranty stock resembled the common stock of other corporations.

In contrast, the acquiring corporation, Citizens Federal Savings and Loan Association, was a federally chartered, mutual savings and

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197. Id. at 630. See also note 7 supra (quoting these Code sections).
198. Id. at 629-30.
199. Id. at 629.
200. Id.
201. Id. In any matter requiring the vote of the members, the savings account holders received one vote per $100 in their accounts; stockholders received one vote per share; and each borrower received one vote. Id.
202. Id. Article VI of the Articles of Incorporation of Commerce Savings and Loan stated that the "minimum amount of such stock shall be $75,000 when issued and shall be fully paid and maintained as fixed and permanent non-withdrawable capital." See Joint Appendix to the Parties Briefs to the U.S. Supreme Court, Paulsen.
203. The bylaws submitted as evidence to the Tax Court stated that both the savings account holders and guaranty stockholders would have a proportionate proprietary interest in the association's assets or net earnings. Paulsen v. Commissioner, 78 T.C. 291, 292 n.2 (1982). In contrast, § 33.48.080 of the Washington Revised Code provided:

Each member having guaranty stock in an association shall have a proportionate proprietary interest in its assets and net earnings subordinate to the claims of its creditors...; but... no other member... shall have any such interest... .

WASH. REV. CODE ANN. § 33.48.080 (Supp. 1981). However, Commerce Savings and Loan's bylaws resolved this apparent conflict by providing that the state law would control where the two were in conflict. Id.
204. Id.
205. Id.
Like Commerce Savings and Loan, Citizens Savings and Loan did not have any capital stock. Instead, the membership in Citizens Savings and Loan consisted solely of the savings account holders and borrowers. The amount of a savings account holder's deposits determined the number of votes the individual received, whereas each borrower automatically received one vote.

The charter of Citizens Savings and Loan provided that it could only raise capital “by accepting payments on savings accounts representing share interests in the association.” Thus, the savings account holders constituted the sole owners of Citizens Savings and Loan. Citizens Savings and Loan distributed its net earnings semi-annually to its savings account holders according to their amounts on deposit. A pro rata distribution would occur upon the liquidation or dissolution of the association. In addition, the charter required that the association honor written requests for withdrawal within thirty days after requested.

On June 30, 1976, Paulsens owned 17,459 shares of Commerce Savings and Loan guaranty stock. Pursuant to a plan of merger, they exchanged all of their Commerce Savings and Loan stock for passbook savings accounts of Citizens Savings and Loan. A restriction...
tion on the passbook accounts prohibited any withdrawals for a period of one year.\(^{217}\) Paulsens also exercised the option to exchange guaranty stock for one- to ten-year time certificates.\(^{218}\) In essence, Paulsens exchanged their Commerce Savings and Loan guaranty stock with a cost basis of $56,802 for $209,508 worth of Citizens Savings and Loan passbook accounts and certificates of deposit.\(^{219}\) The Service required the Paulsens to recognize a $152,706 gain from the transaction.\(^{220}\) In contrast, Paulsens contended that Code sections 354(a)(1) and 368(a)(1)(A) deferred recognition of the gain.\(^{221}\)

To resolve the conflict, Paulsens petitioned the United States Tax Court, seeking a redetermination of the tax deficiency assessed on the exchange.\(^{222}\) The Tax Court held that the transaction satisfied the continuity of interest doctrine and therefore qualified as a tax-free reorganization.\(^{223}\) The court reasoned that the need for certainty, particularly due to the "plight" of the savings and loan associ-

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\(^{217}\) Paulsen, 105 S. Ct. at 629.

\(^{218}\) Id. A small amount of the Commerce Savings and Loan guaranty stock was exchanged for a Citizens Savings and Loan time certificates of deposit with a one-year to ten-year maturity. Id.

\(^{219}\) The chart from the Tax Court opinion illustrates in detail the exchange:

<table>
<thead>
<tr>
<th>Number of shares</th>
<th>Date of acquisition</th>
<th>Cost basis</th>
<th>Consideration received</th>
<th>Gain Realized</th>
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<td>Type</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Amount</td>
<td></td>
</tr>
<tr>
<td>3,356</td>
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<td>$ 7,500</td>
<td>$40,272</td>
<td>$32,772</td>
</tr>
<tr>
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<td>6/26/70</td>
<td>7,500</td>
<td>40,308</td>
<td>32,808</td>
</tr>
<tr>
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<td>10/24/72</td>
<td>7,500</td>
<td>40,296</td>
<td>32,796</td>
</tr>
<tr>
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<td>1/1/73</td>
<td>7,530</td>
<td>8,004</td>
<td>474</td>
</tr>
<tr>
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<td>2/19/74</td>
<td>6,000</td>
<td>23,652</td>
<td>17,652</td>
</tr>
<tr>
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<td>7,500</td>
<td>10,332</td>
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<tr>
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<td>6/30/76</td>
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<td>56,802</td>
<td>209,508</td>
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</tr>
</tbody>
</table>

Paulsen, 78 T.C. at 295.

\(^{220}\) See Paulsen, 105 S. Ct. at 629.

\(^{221}\) Id. See note 7 and accompanying text supra.

\(^{222}\) See Paulsen, 78 T.C. at 291-92.

\(^{223}\) Id. at 297, 303.
ation, required the court to follow the precedent established by the circuit courts.224

On appeal, the United States Court of Appeals for the Ninth Circuit reversed the Tax Court's decision.225 The court reasoned that the accounts could not be classified as equity because the mutual savings accounts did not have sufficient equity characteristics.226 Relying heavily on its decision in Home Savings & Loan Association v. United States,227 the Ninth Circuit addressed the deficiencies in the Paulsens' arguments concerning the equitable rights represented by their mutual shares. First, the court noted that voting rights did not necessarily make an interest an equity interest, since under California law creditors may have voting rights.228 It also indicated that the fixed, preannounced rate paid to all accounts as dividends closely resembled an interest payment.229 The court reasoned that the nature of the mutual accounts should not be determined by a speculative and insignificant right to participate in the proceeds upon the liquidation of the association's assets.230 As further support for its holding,

224. Id. at 303 & n.24. The court noted that other taxpayers had probably relied on the applicable precedents in effecting savings and loan mergers, and thus, desired a uniform rule to be applied nationwide. Id. at 303 n.24. The Tax Court identified the line of circuit court decisions which recognized the mutual savings accounts as possessing sufficient proprietary characteristics, despite their hybrid nature, to satisfy the continuity of interest doctrine: Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970 (Ct. Cl. 1979); Westside Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 494 (6th Cir. 1974); and Everett v. United States, 448 F.2d 357 (10th Cir. 1971). See notes 146-78 and accompanying text supra. The court noted that it should focus on the nature of the interest received. Paulsen, 78 T.C. at 301 (citing Capital, 607 F.2d at 976). The court noted that the Commissioner cited the Ninth Circuit opinion in Home Sav. & Loan Ass'n v. United States, 514 F.2d 1199 (9th Cir. 1975), in support of its position that a tax-free reorganization did not occur. The court distinguished the Paulsen case as presenting an issue of the nature of mutual savings account, which the Ninth Circuit did not address. Paulsen, 78 T.C. at 302 & n.21.


226. Id. at 567.

227. See notes 179-89 and accompanying text supra. See also Note, Taxation - Corporate Reorganization - Withdrawable Shares of Savings and Loan Association Held to be Debt Securities, 44 FORD. L. REV. 687 (1975) (discussing Home Sav. & Loan in depth).

228. See CAL. CORP. CODE §306 (West 1977)(providing voting rights to debt holders). The court noted that generally the depositors gave management their voting rights by way of proxy upon opening their accounts. Paulsen, 716 F.2d at 567.

229. See note 228 supra.

230. Paulsen, 716 F.2d at 568. The court noted that, in Home Savings & Loan, the Ninth Circuit attached no weight to a similar right. Id. The Paulsen court referred to Society for Sav. v. Bowers, 349 U.S. 143, 150 (1955), where the Supreme Court stated: [I]t stretches the imagination very far to attribute any real value to such a remote contingency [as a solvent liquidation], and when coupled with the fact that it represents nothing which the depositor can readily transfer, any theoretical value reduces almost to the vanishing point. Paulsen, 716 F.2d at 568.
the court noted that the withdrawable shares and time certificates received by Paulsens were not permanent capital contributions and concluded that Paulsens' interest would not be subordinate to creditors' interests. 231

Affirming the Ninth Circuit, the Supreme Court ruled that the transaction did not satisfy the continuity of interest requirement for a tax-free reorganization. 232 The Court disregarded, point-by-point, the contentions as to the equity characteristics of the mutual share account advanced by Paulsens, concluding instead that the mutual share account represented a superficial equity interest. 233 The proprietary interest did not represent a substantial interest because it diminished when spread among a greater number of people, as was the case with Citizens Savings and Loan. 234 The Court discounted the shareholders' right to vote, stating that the dilution of the votes by the regular addition of borrowers, who were also entitled to one vote, resulted in an insignificant right. 235 Agreeing with the Ninth Circuit, the Court did not regard the payments on the savings accounts as dividends, but rather as an interest payment because of the preannounced, fixed rate paid to all accounts. 236 Furthermore, the improbability of a solvent liquidation caused the Court to place less significance on the right to participate in the proceeds upon liquidation. 237

Because it found the equity characteristics to be of no import, the Supreme Court emphasized the debt characteristics of the hybrid instrument. 238 The fixed, preannounced rate of return and the non-subordination of the accounts to creditors' claims made the interest a

231. Id. The court also relied on the Fourth Circuit's opinion in York v. Federal Home Loan Bank Bd., 624 F.2d 495 (4th Cir. 1980), as support for its contention that the mutual shareholders did not have sufficient equity interests in the association. Paulsen, 716 F.2d at 569. In York, the court stated: "[A]lthough the depositors are the legal ‘owners’ of a mutual savings and loan, their interest is essentially that of creditors of the association and only secondarily as equity owners." York, 624 F.2d at 499-500.

232. Paulsen, 105 S. Ct. at 632, 634. The Supreme Court recognized the hybrid nature of the mutual share account. Id. at 631.

233. Id. at 631-33.

234. Id. at 631 (contrasting a mutual association with a stock association, because "[u]nlike a stock association where the ownership of the assets is concentrated in the stockholders, the ownership interests [in a mutual association] are spread over all of the depositors").

235. Id. In addition, the Court pointed out that each share account holder is limited to a maximum of 400 votes regardless of the amount in the account. Id.

236. Id.

237. Id. at 632. Citing Society for Sav. v. Bowers, 249 U.S. 143 (1918), the Court observed that not much value is attributed to a fact which is "such a remote contingency," especially when coupled with the depositors' inability to transfer readily the interest. Id.

238. Id.
Moreover, the Court noted that the Paulsens received primarily cash, represented by the withdrawable accounts, in comparison to a very small amount of equity. The Court reasoned that the equity interest received was not substantial, especially in light of the greater equity interest represented by stock in a stock association. The decision characterized the interest received as debt, and thus, it did not satisfy the continuity of interest requirement.

Justice O'Connor, joined by Chief Justice Burger, dissented, referring to the Court's holding as "unwise as a matter of policy and unwarranted as a matter of law." Justice O'Connor agreed with the majority that the mutual share account is a hybrid instrument, but stated that the court erred in valuing separately the debt and equity characteristics. Moreover, she noted that the majority's approach differed substantially from that taken by earlier courts. Ultimately, this approach would result in the reduction of the equity interest in the mutual association to a point where it no longer existed. Justice O'Connor recognized the negative effect the Court's decision may have on legitimate business transactions. Viewing the mutual share account as representing the sole and substantial equity interest in a mutual association, Justice O'Connor reasoned that the transaction satisfied the continuity of interest requirement.

ANALYSIS

Review of the Mutual Share Account

The Paulsens exchanged stock for share accounts and time certificates in the acquiring association pursuant to a plan of reorganization. The statutory merger satisfied the literal language of Code

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239. Id. The Citizens Savings and Loan share account holders could withdraw their deposits with 30-days advance notice, and, upon such notice, Citizens Savings and Loan was required to honor the request. Id.
240. See id.
241. Id. at 633.
242. Id. at 632.
243. Id. at 634 (O'Connor, J., dissenting). Justice O'Connor stated that the majority's holding introduced an element of uncertainty into tax law that was not necessary. Id.
244. Id. at 636.
245. Id.
246. Id.
247. Id. at 638.
248. Id. at 636.
249. Id.
250. Paulsen, 105 S. Ct. at 628-29. See also notes 216-19 and accompanying text supra.
sections 354(a)(1) and 368(a)(1)(A). However, the courts have consistently held that a tax-free reorganization cannot be achieved by mere compliance with the literal language of the statutes. The continuity of interest doctrine, which emerged from the early Supreme Court decisions, requires the shareholder in the acquired corporation to receive a "definite and material" interest in the acquiring corporation. Moreover, that interest must represent a "substantial part of the value of the thing transferred." Traditionally, the courts have also held that the consideration received must have equity characteristics. The Paulsen decision turned on the failure of the surviving interest, mutual share accounts, to satisfy the Court's concept of a proprietary interest.

The Supreme Court in Paulsen split the mutual share account, a single instrument of consideration, in order to value separately its debt and equity characteristics. The Paulsen Court cited Revenue Ruling 69-265 as authority for its fragmentation of the share account. In this ruling, the Service determined that the conversion rights in convertible preferred stock may constitute "property rights other than voting stock." The Service did not actually state, however, that the interest or rights in the stock were separable. In contrast to the Paulsen Court's approach, courts traditionally have

251. Paulsen, 105 S. Ct. at 630.
252. Id.
255. See, e.g., LeTulle v. Scofield, 308 U.S. 415, 420 (1940); Capital Sav. & Loan Ass'n v. United States, 607 F.2d 970, 974-75 (Ct. Cl. 1979); West Side Fed. Sav. & Loan Ass'n v. United States, 494 F.2d 404, 409 (6th Cir. 1974).
256. Paulsen, 105 S. Ct. at 630. One commentator has characterized the Court's decision as "merely an escape hatch to reach a desired result," failing to consider the policy reasons behind the continuity of interest doctrine. Henkel, Paulsen v. Commissioner: Supreme Court Follows Minnesota Tea to a Tee, 63 TAXES 647, 654 (1985).
258. Rev. Rul. 69-265, 1969-1 C.B. 109, 109-10. This Revenue Ruling addressed the issue of whether a subsidiary's acquisition of assets in an unrelated corporation in exchange for stock in the subsidiary's parent corporation, where such stock may have been converted into stock of the parent, qualified as a Type C reorganization. Id. at 109.
259. Paulsen, 105 S. Ct. at 633. The Paulsen Court also cited Gregory v. Helvering, 293 U.S. 465, 469-70 (1935). Paulsen, 105 S. Ct. at 633. Although the Gregory decision supports the position that mere sales should not be afforded tax-free status, the transaction involved stock, not a hybrid instrument such as a mutual share account, and thus, splitting of the interest received was not necessary. See also note 71 supra.
260. Rev. Rul. 69-265, 1969-1 C.B. 109, 109-10. The Service gave alternative rulings based on whether the conversion rights were an option of the first-tiered corporation or an actual right owned by the first-tiered corporation. Id.
not fragmented a single instrument into its component parts.\textsuperscript{261} Rather, the classification of a single instrument is considered an "all-or-nothing question."\textsuperscript{262}

Revenue Ruling 69-265 did not expressly state that one may separate the interest received; however, in Revenue Ruling 69-646, the Service split the equity and debt interests represented by passbook accounts in the acquired building and loan association.\textsuperscript{263} It seems odd that the \textit{Paulsen} Court did not rely on Revenue Ruling 69-646 to support its approach to the separate valuing of accounts. Nor did the \textit{Paulsen} Court distinguish Revenue Ruling 69-6, where the Service held that the debt interest represented by a mutual share account "is not severable" from the proprietary interest.\textsuperscript{264} The omission of the Court in this regard suggests that the mutual share account may receive different treatment depending on the facts of the transaction.

Several potential problems may arise as a result of the Court's separate valuation approach. First, the majority's approach may defeat any claim to a continuing proprietary interest by a mutual shareholder because of the ultimate reduction of the "equity component" of the mutual share account.\textsuperscript{265} Contrary to the \textit{Capital} court's refusal to conclude that the proprietary interest represented by the share account was insufficient,\textsuperscript{266} the majority's approach may lead to a situation where the mutual association is treated as having no owners.\textsuperscript{267} Moreover, the separate valuation and independent weighing of the debt and equity characteristics may lead to inconsistent court

\begin{footnotes}
\item[261] B. Bittker \& J. Eustice, supra note 5, \S 4.02, at 4-7, \textit{cited in Paulsen}, 105 S. Ct. at 636.
\item[262] \textit{Id.} \textit{See also} Comment, supra note 141, at 194.
\item[264] Rev. Rul. 69-6, 1969-1 C.B. 104, 104. \textit{See notes 125-30 and accompanying text supra.}
\item[265] \textit{Paulsen}, 105 S. Ct. at 636. (O'Connor, J., dissenting). The majority viewed the equity interest in the mutual share account following a merger of a stock savings and loan into a mutual savings and loan as so small that a continuity of proprietary interest did not exist. \textit{Id.} at 631-32. However the majority noted that a merger of two mutuals with shares having equivalent cash values would satisfy the doctrine. \textit{Id.} at 633. A difficulty with this distinction is highlighted in a situation described by Justice O'Connor. Justice O'Connor refers to a transaction wherein "a more heavily-capitalized mutual association is acquired by a thinly-capitalized mutual association." \textit{Id.} at 636 (O'Connor, J., dissenting). In this setting, though it appears that the proprietary interest has been reduced by virtue of the thinly-capitalized mutual savings and loan's survival, the majority's test may be satisfied by the exchange of equivalent cash values. \textit{Id.} Justice O'Connor viewed this situation as similar to the exchange in \textit{Paulsen}, where the sole equity interest in the stock savings and loan was exchanged for the sole equity interest in the mutual savings and loan. \textit{Id.}
\item[266] \textit{See note 174 and accompanying text supra.}
\item[267] \textit{See note 177 and accompanying text supra.}
\end{footnotes}
These unpredictable judicial decisions may stymie tax planners in structuring tax-free reorganizations for mutual savings and loans and cause unnecessary litigation.

Not only the Court's separation of the share account, but also its analysis of the individual characteristics of the debt and equity components are suspect. The Paulsen Court held that the depositor's limited number of votes and the right of the borrower to vote combined to dilute one of the equity characteristics of the mutual share account—the right to vote. The early Supreme Court decisions, particularly Minnesota Tea Co., emphasized the requirement that a shareholder in the acquired corporation obtain a "definite and material" interest in the affairs of the acquiring corporation. The courts look for a continuation of interest by the corporation's owners. However, shareholders may satisfy this requirement even if they do not have voting rights. Thus, courts in the future should not base their characterization of the proprietary interest represented by the mutual share account upon the possible dilution of the taxpayer's voting rights.

Additionally, the early Supreme Court decisions examined transactions where the taxpayer received both stock and another form of consideration. For example, in Minnesota Tea Co., the Court evaluated the effect of the "cash" consideration on the entire transac-

268. Cf. Cleveland Bd. of Educ. v. Loudermill, 105 S. Ct. 1487, 1504 (1985) (Rehnquist, J., dissenting) (each recurring procedural due process case will involve different facts and new issues). In Loudermill, the Supreme Court engaged in a balancing of competing private and governmental interests in providing a due process analysis for discharging a governmental employee. Id. at 1494. Justice Rehnquist, in contrast to his Paulsen opinion, objected to the balancing test imposed by the Court, stating:

The balance is simply an ad hoc weighing which depends to a great extent upon how the Court subjectively views the underlying interests at stake. . . . The lack of any principled standards in this area means that these procedural due process cases will recur time and again. Every different set of facts will present a new issue on what process was due and when.

Id. at 1504 (Rehnquist, J., dissenting). Likewise, a balancing of the debt and equity characteristics by the Court, without some "principled standards," may lead to inconsistent holdings.

269. See notes 232-35 and accompanying text supra.


273. See Minnesota Tea Co., 296 U.S. at 381 (acquired corporation's shareholders received voting trust certificates and cash); Nelson, 296 U.S. at 376 (acquired corporation's shareholders received preferred stock and cash).
In Paulsen, the acquired corporation's shareholders received only share accounts and time certificates. The share accounts represented the sole proprietary interest in the mutual savings and loan. As such, it is possible to view the interest received by the taxpayers as "definite and material" and a "substantial part of the value of the thing transferred."277

The Paulsen Court also should have examined the rationale underlying the reorganization statutes. Congress intended to promote desirable business transactions through flexible tax-free reorganization provisions.278 The economy has caused trouble for the savings and loan industry in recent years.279 By effectively precluding any tax-free merger of a stock savings and loan into a mutual savings and loan, the Court failed to consider early congressional policy and the current needs of industry members.

Following Paulsen, it becomes necessary to restructure the reorganization of savings and loan associations to avoid the pitfalls of the decision. Possible alternatives exist to the departure of the Paulsen Court from the traditional characterization of a mutual share account as "all debt" or "all equity."280 One alternative is that courts institute a "recognizable gain test."281 This alternative proposes that a taxpayer should not recognize a gain or loss until he disposes of the interest received in a reorganization in a subsequent taxable event.282 This test is based upon the concept that the taxpayer's interest does not change following an acquisition or merger.283 In Paulsen, since the Paulsens had to wait at least thirty days before withdrawing the funds,284 they arguably did not have immediate funds with which to pay their taxes. The administration of this test though would be dif-

274. Minnesota Tea, 296 U.S. at 386. See also Reply Brief for the Petitioners at 4, Paulsen.
276. Id. at 631.
277. See Minnesota Tea Co., 296 U.S. at 385 (transfer of voting trust certificates representing sole equity interest was "definite and material" and a "substantial part" of the transfer).
278. See notes 34-49 and accompanying text supra. Moreover, a Senate Hearing Report of 1924 states:
   Congress . . . adopted the policy changes made in connection with a reorganization, in order that ordinary business transactions [would] not be prevented on account of the tax law.
279. See notes 1-2 and accompanying text supra.
281. Id.
282. See Comment, supra note 141, at 196.
283. Id. The taxpayer must withdraw the funds or sell the account before he attains any economic benefit from the transaction. Id.
284. Id. See note 239 supra.
difficult for the Service, since each portion of the gain or loss would be recognized individually upon its own taxable event. However, it might be no more difficult than the accounting for stock sales by a taxpayer who owns stock with various bases. Perhaps, the entire amount in the fund could be taxed upon the first taxable transaction as opposed to recognizing each portion of the gain or loss individually.

Revenue Ruling 69-646 provides the basis for a second alternative, the two-step “pro-rata interest” test. This test also applies to a savings and loan merger without attempting an “all or nothing” characterization of the interest. The first step, involving the exchange of mutual share accounts, would be tax free, as the taxpayer merely substitutes one form of cash deposits for another. In the second step, the shareholders of the stock savings and loan association exchange their stock for mutual accounts. The shareholder’s pro rata interest in the savings and loan’s undivided profit and reserves on the date of the transaction determines the equity value of their mutual account. Thus, to the extent, if any, that the exchange of stock exceeds the equity interest in the mutual account, the transaction is taxable. Although the pro rata interest test provides a simple formula which the courts may apply consistently, it clearly contradicts Revenue Ruling 69-6, wherein the Service opposed the splitting of debt and equity interests.

The rationale for treating Type A statutory mergers differently from the other types of statutory mergers is questionable. Since Congress has specified the types of interest which will satisfy the requirements for the other types of reorganizations, Congress should take a similar approach to the Type A reorganization. Regardless of what action Congress may take, the courts must be consistent in their treatment of stock-to-mutual reorganizations. By being aware

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286. Id. Additionally, it would be difficult for the Service to determine that any money withdrawn after the taxpayers deposited funds unrelated to the reorganization was attributable to the funds acquired from the reorganization. See id. at 42.
287. Henkel, supra note 256, at 653.
288. Id.
289. See notes 131-37 and accompanying text supra.
290. See Comment, supra note 141, at 199.
291. Id. at 198.
292. See Comment, supra note 141, at 198.
294. See Comment, supra note 141, at 199.
295. Id. at 200. See also note 128 and accompanying text supra.
296. Faber, supra note 40, at 263.
297. Id.
of the \textit{Paulsen} decision, creative tax planners may overcome obstacles to attain the economic opportunities necessary for the continued vitality of the savings and loan industry. Additionally, the \textit{Paulsen} decision leaves uncertain the courts' separate valuation of the equity and debt interests in future decisions. In this light, judicial adoption of one of the proposed separate valuation alternatives may add structure to the Court's decision.

\textit{Congressional Proposal}

Preferably, Congress should restructure the corporate tax law as it relates to corporate reorganizations. A proposal to aid in this reform is currently before Congress. On May 20, 1985, the Senate Finance Committee issued a final report on revisions of the Code's corporate tax provisions, suggesting changes to current laws concerning corporate mergers and acquisitions.\footnote{See \textit{Senate Finance Comm., Analysis of the Subchapter C Revision Act of 1985}, S. REP. NO. 47, 99th Cong., 1st Sess. (1985), \textit{reprinted in} 27 \textit{Tax Notes} 1047 (May 27, 1985). This report is substantially similar to the 1983 preliminary report prepared by the Staff of the Senate Committee. See \textit{Staff of Senate Comm. on Finance, 98th Cong., 1st Sess., The Reform and Simplification of the Income Taxation of Corporations} (Comm. Print 1983). Each of these proposals is based in part upon a study conducted by the American Law Institute ("ALI"). For a review of the ALI proposal, see Wolfman, "Continuity of Interest" and The American Law Institute Study, 57 \textit{Taxes} 840 (1979)(actual proposal attached as an appendix).}

At the corporate level, an "elective nonrecognition-carryover-basis system" would replace the present multitude of acquisitive reorganization rules.\footnote{B. BITTKER \& J. EUSTICE, supra note 5, \S 14.21 at 14-34 (Cum. Supp. No. 2 1985). The proposal would replace the Types A, B, and C reorganizations found in §§ 368(a)(1)(A), 368(a)(1)(B), and 368(a)(1)(C).} Corporate reorganizations would be divided between "qualified asset acquisitions" and "qualified stock acquisitions."\footnote{Milner, \textit{Boot Under the Senate Finance Committee's Reorganization Proposal: A Step in the Wright Direction, but Too Far}, 62 \textit{Taxes} 507, 508 (1984). A "qualified asset acquisition" occurs when the transaction involves a statutory merger, consolidation, or any other transaction where the acquiring corporation acquires substantially all (a minimum of 90\% of the assets' net fair market value and 70\% of the assets' gross fair market value) of the acquired corporation's assets. See \textit{Senate Finance Comm., supra note} 298, at 1047. In contrast, a "qualified stock acquisition" is a transaction or series of transactions where the acquiring corporation must obtain control (80\% of voting stock and 80\% of total value of all other stock) of the acquired corporation. \textit{Id.} at 1047, 1051.} The proposal provides that the parties to a corporate acquisition may elect the tax consequences without regard to the type of consideration received.\footnote{See \textit{Senate Finance Comm., supra note} 298, at 1047-48. See also B. BITTKER \& J. EUSTICE, supra note 5, \S 14.21, at 14-35 (Cum. Supp. No. 2 1985). All qualified acquisitions are presumed to take a carryover basis in corporate assets unless an express election for cost basis is made. \textit{Id.} at 14-36.} If the parties elect a carryover basis in the corporate assets, then the
transaction is entitled to nonrecognition treatment. If the parties elect a cost basis in the corporate assets equal to the assets' fair market value, the gain or loss from the transaction is recognized.

The proposal additionally addresses the tax consequences at the shareholder level in a corporate acquisition. The proposal is unique in that taxation at the shareholder level is unrelated to the corporate election. Moreover, the tax consequences are determined on a separate shareholder-by-shareholder basis. Thus, the transactional continuity of interest would be eliminated and replaced with a type of individual continuity of interest. Shareholder tax treatment depends solely on the type of consideration received.

For example, a shareholder may receive qualifying consideration (stock) tax free; however, the full amount of any non-qualifying consideration (boot) is recognized as gain. Another change at the shareholder level is the revised treatment of boot. The Senate Finance Committee's plan uses a "dividend equivalence test." If the boot is equivalent to a dividend, it is treated as ordinary income as opposed to capital gain.

303. Id.
305. Senate Finance Comm., supra note 298, at 1048; Staff of Senate Comm. on Finance, supra note 298, at 62.
308. Id.
309. Id. See also Senate Finance Comm., supra note 298, at 1048. Qualifying consideration includes securities of the acquiring corporation. Id.
310. See generally Milner, supra note 300, at 510-11 (reviewing and analyzing the treatment of boot under the committee's proposal).

The preliminary report defines the proposed test as follows: Dividend equivalence for distributed boot would be tested by assuming that the shareholders of the acquired corporation transferred all of their stock in exchange for stock of the acquiring corporation and then had a portion of the stock redeemed.

Staff of Senate Comm. on Finance, supra note 298, at 63. This rule will resolve a conflict between the circuit courts under current law. Id. The test would be applied to the shareholder's interest in the acquiring corporation, accepting the Eighth Circuit's opinion in Wright v. United States, 482 F.2d 600 (8th Cir. 1973), and rejecting the Fifth Circuit's opinion in Shimberg v. United States, 577 F.2d 283 (5th Cir. 1978), which focused on the shareholder's interest in the acquired corporation. See also Rev. Rul. 75-83, 1975-1 C.B. 112, 113-14 (same approach later taken by the Shimberg court).
312. Milner, supra note 300, at 510. The preliminary report provides the following two examples of how the dividend equivalence test would operate:

P corporation acquires T corporation through merger. Under the terms of the merger agreement, the T shareholders receive 10 percent of the outstanding P
The proposal by the Senate Finance Committee is undoubtably a step in the right direction to resolve the application of a difficult doctrine. The committee's proposal maximizes the tax planning opportunities at both the corporate and shareholder level.\(^{313}\) At the corporate level, a tax advisor may currently structure a transaction in accordance with the statutory provisions to obtain a desired tax result.\(^{314}\) However, the continuity of interest doctrine may impede the intended transaction.\(^{315}\) The proposal's election mechanism frees the corporate taxpayer from encumbering statutes and ambiguous doctrines. Thus, the taxpayer may select, prior to the transaction, the desired tax treatment without incurring costly tax advice.\(^{316}\) The tax planning benefits are evident not only at the corporate level but also at the shareholder level. The hardship incurred by the individual shareholder under current law is primarily due to its focus upon the entire transaction to determine whether the continuity of interest requirement is met.\(^{317}\) The tax treatment of a shareholder may be determined by an event beyond the shareholder's control or knowledge.\(^{318}\) Divorcing the shareholders from each other and the corporate level transaction is consistent with tax policy. The proposal requires that the shareholder's ability to pay and the extent of individual control determine the recognition of a taxable event.\(^{319}\)

Congressional action would enable the savings and loan industry...
to rise above the plague of financial difficulties it has experienced in recent years.\textsuperscript{320} A reform should emphasize the policy to remove any hindrance from effective tax planning of corporate reorganizations. Clearly, the Senate Finance Committee's proposal effectively eliminates the difficulties arising under current law, accomplishing this task in a straightforward manner.

CONCLUSION

Congress, in an effort to promote economic growth, fashioned provisions in the Code to allow for flexible business reorganizations. Recognizing this policy and desiring to preserve its integrity, the courts created the continuity of interest doctrine to prevent taxpayer abuse of the provisions. The courts strove to retain in the acquiring corporation the shareholder's proprietary interest held in the acquired association. Until recently, courts have focused on the interest as a whole. However, in Paulsen, the Supreme Court digressed from the established doctrine by separating an interest in a mutual savings and loan into its individual debt and equity characteristics. The Court developed a framework for determining whether the requisite continuity of interest exists, whereby it will weigh the separate characteristics of a mutual share account. This analysis, if continued, will result in an added burden to the plight of the savings and loan industry. Thus, the Court should reevaluate its holding and apply a test, which balances its concerns as to taxpayers' abuse of the Code provisions with the congressional policy of promoting economic growth, in the unstable economy faced by the savings and loan industry.

Catherine K. Anderson—'87
