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Analyzing the Continuity of Interest Doctrine: Paulsen v. Commissioner

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NOTES

ANALYZING THE CONTINUITY OF INTEREST DOCTRINE: *PAULSEN V. COMMISSIONER*

IN 1976 Harold and Marie Paulsen exchanged guaranty stock¹ in Commerce Savings and Loan Association, a state chartered savings and loan association, for savings accounts and time certificates of deposit² in Citizens Federal Savings and Loan Association, a federally chartered mutual savings and loan association.³ The associations arranged the exchange pursuant to a plan of merger.⁴ The capital structure of Commerce had consisted of guaranty stock and several classes of savings accounts. Under the governing state law only holders of guaranty stock had a proprietary interest in Commerce's earnings and assets.⁵ As a mutual savings and loan association Citizens had no stock.⁶ Savings accounts and certificates of deposit

1. Guaranty stock consists of permanent stock that is subordinate to creditors' claims. *In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 99 P.2d 251, 255 (1940). Savings and loan associations issue guaranty stock to establish reserve funds for the protection of other investors in the association. *Id.*

2. A savings account is a demand account that provides for the payment of interest to the depositor. 1 W. SCHLICHTING, T. RICE & J. COOPER, *BANKING LAW* § 9.02[2] (1982). Deposits that the bank agrees to relinquish to the depositor after a specified period at a predetermined rate of interest qualify as time certificates of deposits. *Id.* Any premature withdrawal of the deposit by the depositor results in a forfeiture of interest. *Id.*

3. The Federal Home Loan Bank Board authorized and chartered Citizens under the provisions of 12 U.S.C. §§ 1461-1470 (1982) and the regulations promulgated thereunder. *Id.* § 1464(b)(1)(A) authorizes an association to raise capital in the form of savings deposits, shares, or other accounts such as passbook accounts and time certificates of deposit. The statute does not authorize the issuance of stock as a means of raising capital.

4. The plan of merger provided for the exchange of each share of guaranty stock in Commerce for a \$12 deposit in a passbook savings account in Citizens, subject to the restriction that the shareholders could not withdraw such deposits within one year from the date of the merger. Alternatively, Commerce stockholders could exchange their stock for time certificates of deposits in Citizens with maturities ranging from one to ten years. Each Commerce savings account would convert to an identical Citizens savings account.

5. *Paulsen v. Commissioner*, 716 F.2d 563, 564 (9th Cir. 1983). Commerce operated under the laws of Washington, its state of incorporation. The bylaws of Commerce stated that both the holders of guaranty stock and savings accounts had a proprietary interest in the assets or net earnings of the association. The bylaws further stated that any bylaw provision conflicting with state law was to be deemed to conform to the state law. The Washington Revenue Code provides that each guaranty stockholder of an association had a proprietary interest in the assets and net earnings of the association, and no other member of the association had any such interest. WASH. REV. CODE ANN. § 33.48.080 (Supp. 1981).

6. The capital structure of mutual savings and loans consists of share accounts, deposits, or time certificates of deposit. The capital of stock savings and loans, however, consists of guaranty or capital stock in addition to share accounts. Comment, *Classification of Share-*

comprised the only form of ownership interest in the association; however, Citizens shareholders had the right to vote, the right to dividend distributions of the association's net earnings, and the right to a pro rata distribution of any remaining assets after a solvent dissolution.⁷

Relying on sections 354(a)⁸ and 368(a)(1)(A)⁹ of the Internal Revenue Code of 1954, as amended, the Paulsens excluded the gain realized as a result of the merger from their 1976 federal income tax return. The Internal Revenue Service issued a federal income tax deficiency notice to the Paulsens requiring them to recognize in 1976 the gain realized from the exchange. The Paulsens subsequently sought a redetermination of the deficiency in the United States Tax Court, asserting that an exchange of stock in Commerce for an equity interest in Citizens deserved tax-free treatment under sections 354 and 368(a)(1)(A) of the Code. The IRS contended that the merger of the two associations did not meet the requirements of a tax-free reorganization under section 368(a)(1)(A) because the Paulsens did not receive a significant proprietary interest in the mutual savings and loan association.

In holding for the plaintiffs, the Tax Court held that savings accounts constitute proprietary interests that satisfy the continuity of interest required of a reorganization under section 368(a)(1)(A) of the Code; therefore, the Paulsens did not have to recognize gain from the exchange.¹⁰ The IRS appealed to the United States Court of Appeals for the Ninth Circuit. The appellate court reversed the tax court's holding and held that the interests at issue, although ownership interests for some purposes,¹¹ did not possess sufficient equity characteristics to render the merger a tax-free reorganization.¹² The Supreme Court granted certiorari. *Held, affirmed*: The exchange of stock for passbook accounts and certificates of deposit pursuant to a plan of merger fails to qualify as a tax-free reorganization. *Paulsen v. Commissioner*, 105 S. Ct. 627, 83 L. Ed. 2d 540 (1985).

holder Interest in Mutual Savings and Loans for Purposes of Nontaxable Reorganizations Under I.R.C. §§ 354 and 361, 53 U. CIN. L. REV. 177, 178 n.8 (1984).

7. *Paulsen v. Commissioner*, 716 F.2d 563, 564-65 (9th Cir. 1983).

8. I.R.C. § 354(a)(1) (1982) provides: "No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

9. *Id.* § 368(a)(1)(A) provides that the term "reorganization" means a statutory merger or consolidation. *Id.* § 368(a)(1)(C) defines a reorganization as the exchange of voting stock in one corporation for substantially all of the properties of another corporation.

10. *Paulsen v. Commissioner*, 78 T.C. 291, 303 (1982). The Tax Court had not previously considered the question whether mutual savings accounts constitute stock for purposes of the nonrecognition provisions of § 354(a) of the Code. *Id.* at 298. The court noted, however, that a number of other courts that had considered the issue uniformly held that the receipt of savings accounts in a mutual savings and loan association in exchange for stock satisfied the continuity of interest test. *Id.*; for a discussion of the cases cited by the Tax Court, see text accompanying *infra* notes 29-40. The Tax Court held that the mutual shares qualified as stock, based on judicial precedent set by other courts and the need for certainty in the law. 78 T.C. at 303.

11. See *supra* text accompanying note 7 (discussing proprietary rights associated with Citizens mutual shares).

12. *Paulsen v. Commissioner*, 716 F.2d 563, 566 (9th Cir. 1983).

I. REQUIREMENTS OF A TAX-FREE REORGANIZATION

A. Statutory Requirements

A disposition of property, including stock, generally results in a gain or loss that a taxpayer includes when calculating gross income.¹³ One exception to the general rule involves corporate reorganizations.¹⁴ Section 354 of the Code provides for nonrecognition of gain by a shareholder of a corporation that exchanges stock or securities with another corporation pursuant to a plan of reorganization.¹⁵ A transaction qualifies for tax-free treatment under the nonrecognition provisions of section 354 only if it complies with the definition of reorganization under section 368 of the Code.¹⁶

Section 368(a)(1)(A) extends tax-free treatment to an exchange of stock or securities in connection with a statutory merger or consolidation.¹⁷ Literal compliance with the statutory provisions of section 368, however, will not always qualify a merger for tax-free treatment. The exchange must also satisfy the judicially created doctrine of continuity of interest.¹⁸

B. Continuity of Interest Doctrine

The continuity of interest doctrine requires shareholders of an acquired corporation to retain a proprietary interest in the surviving corporation in order to avoid recognition of gain realized in a merger.¹⁹ The courts created

13. I.R.C. §§ 61, 1001(c) (1982).

14. *See id.* §§ 61, 354, 361, 1001. Section 1001 of the Code provides that the taxpayer must recognize gain or loss resulting from the disposition of property unless otherwise provided by the Code. *Id.* § 1001. The corporate reorganization provisions of §§ 354 and 361 constitute an exception to this general rule. *See* B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 14.01 (4th ed. 1979).

15. I.R.C. § 354(a)(1) (1982); *see supra* note 8.

16. *See supra* note 9.

17. I.R.C. § 368(a)(1)(A) (1982); *see supra* note 9.

18. Treas. Reg. § 1.368-1(b) (1955).

19. The continuity of interest doctrine originated in *Cortland Specialty Co. v. Commissioner*, 60 F.2d 937 (2d Cir. 1932). In that case one corporation exchanged its assets for cash and short-term notes of another corporation. Although the transaction met the statutory requirements of a reorganization, the court held that the exchange of cash and short-term notes for the acquired company's stock did not constitute a tax-free reorganization. The court noted that congressional intent required the owners of the acquired corporation to retain a continuity of interest in the surviving corporation in order to receive tax-free treatment. *Id.* at 940. The court concluded that:

In defining "reorganization," section 203 of the Revenue Act [which defined reorganization as in I.R.C. § 368(a)(1)(A)] gives the widest room for all kinds of changes in corporate structure, but does not abandon the primary requisite that there must be some continuity of interest on the part of the transferor corporation or its stockholders in order to secure exemption.

Id. The following year the Supreme Court, citing *Cortland*, adopted the continuity of interest doctrine in *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933). The Court stated that the transferor "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." *Id.* at 470.

During the 1930s and 1940s the Court further refined the continuity of interest doctrine. In *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935), the Supreme Court held that voting trust certificates constituted the equivalent of stock and possessed sufficient equity to satisfy the continuity of interest doctrine. *Id.* at 385-86. The Court, however, added another require-

the continuity of interest requirement to distinguish between mere sales and valid reorganizations in which shareholders exchange an intangible investment in one corporation for an intangible investment in another corporation.²⁰ The doctrine prevents taxpayers from securing tax-free treatment of a transaction through literal compliance with the Code when the substance of the transaction does not warrant nonrecognition treatment.

The Supreme Court has had several opportunities to define the type of interest that a shareholder must receive in order to satisfy the continuity of interest requirement.²¹ The Court has held that receipt of cash or short-term notes by a shareholder does not satisfy the continuity of interest test.²² The Court reasoned that the shareholder, by receiving cash or its equivalent, has either sold his investment interest in the corporation or has become a creditor of the corporation rather than retaining an ownership interest.²³ In addition, the Court has held that bonds received pursuant to a plan of reorganization do not constitute equity interests that satisfy the continuity of interest doctrine.²⁴ Thus, to maintain a proprietary interest in the surviving corporation, the shareholders of the acquired corporation must receive stock or some other form of equity interest.²⁵

ment to the doctrine by stating that the interest received by the acquiree "must be definite and material; it must represent a substantial part of the value of the thing transferred." *Id.* at 385. In *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935), the Court held that preferred stock possessed sufficient equity interest to satisfy the continuity of interest doctrine even though the preferred stock conferred no voting rights. *Id.* at 377. In *LeTulle v. Scofield*, 308 U.S. 415 (1940), the Court held that an acquisition of all of a corporation's properties for cash and bonds did not constitute a reorganization that satisfied the continuity of interest doctrine. *Id.* at 416. *LeTulle* narrowed the scope of an earlier Supreme Court decision that held that mortgage bonds possessed adequate equity interest to satisfy the continuity of interest doctrine. See *Helvering v. Watts*, 296 U.S. 387, 389 (1935). For a more detailed discussion of the judicial history of the continuity of interest doctrine, see B. BITTKER & J. EUSTICE, *supra* note 14, ¶ 14.11; Faber, *Continuity of Interest and Business Enterprise; Is it Time to Bury Some Sacred Cows?*, 34 TAX LAW. 239, 240-50 (1981).

20. The Treasury codified the continuity of interest doctrine in Treasury Regulation § 1.368-1. The regulation provides that the purpose of the reorganization provisions of the Code is to exempt from tax certain exchanges resulting from readjustments of corporate structures. Treas. Reg. § 1.368-1(b) (1955). The regulation further mandates as prerequisites to a reorganization under the Code a continuity of the business enterprise under the modified form and a continuity of interest on the part of the owners of the acquired enterprise. *Id.* See B. BITTKER & L. STONE, *FEDERAL INCOME TAXATION* 1148 (5th ed. 1980). Treasury Regulations prescribed by the Secretary of the Treasury constitute the most authoritative pronouncements on the Code. The regulations serve as a major source of guidance by supplying the taxpayer with an interpretation of the Code. *Id.* Interpretive agency regulations, including Treasury Regulations, have the force and effect of law; however, the courts may overrule them as inconsistent with the Code as well as for abuse of discretion. *Id.* In reality, the courts frequently accord the regulations the force of law and seldom overrule them. *Id.* Revenue Rulings provide an interpretation of substantive tax law for the purpose of promoting uniform application of the tax laws. Revenue Rulings reflect the current policies of the IRS, but do not have the force and effect of law. *Id.* at 1149.

21. *LeTulle v. Scofield*, 308 U.S. 415 (1940); *Helvering v. Watts*, 296 U.S. 387 (1935); *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935); *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933).

22. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 470 (1933).

23. *Id.* at 469; see B. BITTKER & J. EUSTICE, *supra* note 14, at 14-20.

24. *LeTulle v. Scofield*, 308 U.S. 415, 416 (1940).

25. *Id.* at 420-21; *Helvering v. Watts*, 296 U.S. 387, 389 (1935); *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 466-67 (1933); *Cortland Specialty Co. v. Commis-*

In reorganizations involving mutual savings and loan associations, ownership interests possess both debt and equity characteristics.²⁶ Because the nature of the ownership interest has two facets, application of the continuity of interest doctrine to these situations presents considerable difficulty.²⁷ Consequently, various courts have attempted to determine whether the receipt of a mutual share account qualifies as a substantial proprietary or equity interest sufficient to satisfy the continuity of interest doctrine.²⁸

II. CLASSIFICATION OF MUTUAL SHARE ACCOUNTS: THE SAVINGS & LOAN CASES

The issue of whether a savings account in a savings and loan association constitutes debt or equity first arose in *Home Savings & Loan v. United States (Home I)*.²⁹ *Home I* involved the merger of two stock savings and loan associations. Under the plan of merger the acquiring savings and loan association agreed to purchase all of the outstanding guaranty stock of the acquired association for cash. In addition, the depositors and shareholders of the acquired association would exchange their share accounts for similar share accounts in the acquiror. After the merger the depositors of the acquired association would have the same pro rata continuing interest in the acquiror as they had before the merger. Under state law the depositors possessed proprietary interests associated with their shares such as the right to vote and the right to elect members of the board of directors.³⁰ The IRS contended that the transaction did not constitute a reorganization under section 368(a)(1)(A) of the Code, but that the merger represented a liquidation of a subsidiary pursuant to section 332.³¹ The district court determined that share accounts qualify as stock, and since the acquiring association

sioner, 60 F.2d 937, 940 (2d Cir. 1932); see also Treas. Reg. § 1.368-1(b), *supra* note 20 (continuity of interest doctrine). In a recent article two attorneys concluded that stockholders of the acquired corporation must receive an equity interest in the acquiring corporation to satisfy the continuity of interest requirement. Debt, in any form, will not qualify as an equity interest. McGaffey & Hunt, *Continuity of Shareholder Interest in Acquisitive Corporate Reorganizations*, 59 TAXES 659, 661 (1981).

26. Debt characteristics include the ability to convert the shares to cash on demand, the presence of a fixed rate of return, and the nonsubordination of the shares to the claims of creditors. Equity characteristics consist of the right to vote, the right to share in liquidation proceeds of the association, and the right to elect members of the board of directors. See, e.g., *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 411 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 360 (10th Cir. 1971); *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134, 135 (S.D. Cal. 1963); see also, *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 974-76 (Ct. Cl. 1979) (discussion of debt and equity characteristics of mutual shares).

27. Comment, *supra* note 6, at 178.

28. *West Side Fed. Sav. & Loan Ass'n v. United States*, 494 F.2d 404, 409-11 (6th Cir. 1974); *Everett v. United States*, 448 F.2d 357, 359-60 (10th Cir. 1971); *Home Sav. & Loan Ass'n v. United States*, 223 F. Supp. 134, 135 (S.D. Cal. 1963); *Capital Sav. & Loan Ass'n v. United States*, 607 F.2d 970, 973-74 (Ct. Cl. 1979).

29. 223 F. Supp. 134 (S.D. Cal. 1963).

30. *Id.* at 135.

31. Section 332 involves the merger of a subsidiary company into the parent company. I.R.C. § 332 (1982). The section requires the parent corporation to own 80% of the total combined voting stock of the subsidiary corporation. *Id.*

purchased only the guaranty stock of the acquired association, it did not own eighty percent of the total voting power as required by section 332.³² The court recognized that the controlling factor in categorizing the depositors' interests was the "quality of rights, preferences and privileges related to such interest."³³ The court held that the merger constituted a reorganization within section 354(a)(1)(A) and that the transaction satisfied the continuity of interest test.³⁴

The problem of classifying mutual share accounts arose again in *Everett v. United States*.³⁵ *Everett* involved the acquisition of a stock savings and loan association by a mutual savings and loan association. Under the plan of merger holders of full paid shares³⁶ and savings shares³⁷ in the stock association exchanged their shares for like shares in the mutual association.

The share account holders, who possessed over ninety-seven percent of the voting shares in the acquired association, claimed nonrecognition treatment of the exchange under section 368(a)(1)(C) of the Code.³⁸ The government questioned whether the full paid shares and savings shares received from the mutual association qualified as voting stock within the meaning of section 368(a)(1)(C). The Government conceded that the shares possessed some equity characteristics, such as the right to vote and the right to share in liquidation proceeds, but contended that such interests more closely resembled a creditor's interests. The court recognized that the savings shares had some attributes of debt, but noted that the shares also possessed many characteristics of a proprietary interest.³⁹ The court, therefore, held that the full paid shares and savings shares constituted voting stock within the meaning of section 368(a)(1)(C) and thus met the requirements of the continuity of interest test.⁴⁰

*West Side Federal Savings & Loan v. United States*⁴¹ involved a fact situation similar to the one in *Everett*. Relying on *Home I*, the Court of Appeals for the Sixth Circuit held that a statutory merger of a state chartered savings and loan association, which had capital stock in addition to savings accounts, into a mutual savings and loan association with savings accounts as the only capital constituted a tax-free reorganization within the meaning of

32. 223 F. Supp. at 135.

33. *Id.*

34. *Id.*

35. 448 F.2d 357 (10th Cir. 1971).

36. Full paid shares consist of capital stock that is similar to stock issued by a corporation because the purchaser pays par value for the stock. *Mott v. Western Sav. & Loan Ass'n*, 142 Or. 344, 20 P.2d 236, 239 (1933) (citing J. SUNDHEIM, LAW OF BUILDING AND LOAN ASSOCS. § 37 (2d ed. 1922)).

37. See *supra* note 2 for a discussion of savings shares.

38. For description of reorganization under I.R.C. § 368(a)(1)(C), see *supra* note 9.

39. 448 F.2d at 360. The court emphasized that the shares possessed proprietary rights, such as the right to vote, the right to participate in the earnings of the association, and the right to share in liquidation proceeds. *Id.*

40. *Id.* The court referred to I.R.C. § 7701(a)(7) (1982), which provides that the term "stock" includes shares in an association. 448 F.2d at 359-60.

41. 494 F.2d 404 (6th Cir. 1974).

section 368(a)(1)(A).⁴² The plan of merger provided for the mutual savings and loan association to acquire all of the assets and liabilities of the stock savings and loan association. Each savings account holder in the acquired association was to receive a savings account in the acquiror. The IRS recognized that the transaction qualified as a statutory merger within the meaning of section 368(a)(1)(A), but contended that the continuity of interest requirement had not been met. The IRS argued that a withdrawable savings share in a federal savings and loan association amounted to no more than the equivalent of a demand deposit bank account.

The court overruled the government's contention and concluded that the transaction met the continuity of interest test.⁴³ The court noted that the charter of the acquiring savings and loan association stated that holders of savings accounts who had made an application for withdrawal would remain holders of savings accounts until their funds were paid and would not become creditors.⁴⁴ The court further reasoned that in exchange for their stock, the stockholders of the acquired association received shares constituting the sole proprietary interest in the federal mutual savings and loan association.⁴⁵ The court then focused on the proprietary rights that the shareholders received and did not concentrate solely on their rights as creditors.⁴⁶

The Ninth Circuit reached a contrary result in *Home Savings & Loan Association v. United States (Home II)*.⁴⁷ *Home II* involved the acquisition of two stock savings and loan associations by another stock savings and loan association. The capital of each of the participants in the acquisition was in the form of both guaranty stock and withdrawable shares. The acquiring savings and loan association purchased the guaranty stock of both acquired savings and loan associations for cash and exchanged the withdrawable shares of the acquired associations for withdrawable shares of the acquiror.

The Ninth Circuit held that the withdrawable shares and investment cer-

42. *Id.* at 411. The court discussed the judicial history and development of the continuity of interest doctrine, the definitions in § 7701 of the Code, and the hybrid nature of share accounts in mutual savings and loan associations. *Id.* at 406-10; see notes 19, 40 and accompanying text.

43. 494 F.2d at 411. The court examined the position of the IRS with respect to mergers and consolidations of savings and loan associations. *Id.* at 409-10. In Rev. Rul. 3, 1969-1 C.B. 103, the Commissioner ruled that the statutory merger of two mutual savings and loan associations qualified as a tax-free reorganization. In Rev. Rul. 6, 1969-1 C.B. 104, however, a merger of a state chartered stock association into a federally chartered mutual association did not qualify as a tax-free reorganization. Finally, in Rev. Rul. 646, 1969-2 C.B. 54, a merger of a mutual association into a stock association was characterized as constituting a tax-free reorganization. For a discussion of the purpose of Revenue Rulings, see *supra* note 20.

44. 494 F.2d at 411.

45. *Id.*

46. *Id.* The court stated that it would analyze the facts to determine whether a shareholder received a proprietary interest, but would not determine whether such interest increased or decreased as a result of the exchange. *But see* *Southwest Natural Gas Co. v. Commissioner*, 189 F.2d 332, 335 (5th Cir. 1951) (insufficient continuity of interest where stock received represented less than 1% of the consideration).

47. 514 F.2d 1199 (9th Cir.), *cert. denied*, 423 U.S. 1015 (1975).

tificates constituted debt rather than equity based on several factors.⁴⁸ First, the court examined the terms of the share accounts, noting that the shareholders could receive cash virtually on demand.⁴⁹ The court assigned little weight to the fact that share account holders possessed voting rights since holders of debt can also have voting rights.⁵⁰ In reaching its decision, the court relied upon relevant aspects of California law⁵¹ and of the federal tax laws⁵² and cited authors from the savings and loan industry.⁵³ The Ninth Circuit stated, however, that it might have weighed the equity features of the mutual shares more heavily if the transaction had not also involved guaranty stock.⁵⁴

The court concluded by discussing two cases, *Home I*⁵⁵ and *Everett*.⁵⁶ The court ostensibly overruled *Home I* by stating that the result reached in *Home I* conflicted with the holding in *Home II*.⁵⁷ The court refused to express an opinion regarding the IRS's attempt to distinguish *Everett* and *Home II* on the ground that the shareholders of a mutual savings and loan association have more extensive equity rights than shareholders of a stock savings and loan association.⁵⁸ The court acknowledged, however, that the issues involved in the merger of two mutual savings associations differed from the questions raised in *Home II*.⁵⁹

A recent Court of Claims case, *Capital Savings & Loan Association v. United States*,⁶⁰ addressed the classification of mutual share accounts based

48. 514 F.2d at 1205.

49. *Id.* at 1206. The court compared the terms of the shares and certificates with guaranty stock and noted that holders of stock have no right to withdraw cash from the association. *Id.*

50. *Id.*

51. Under California law stockholders incur individual liability to the creditors of the association, including holders of investment certificates, up to the amount of the association's permanent capital in addition to the sum invested in stock. On the other hand, shareholders, certificate holders, and borrowers have no liability to creditors. *Id.* at 1207. The Supreme Court of California had earlier categorized withdrawable shareholders as creditors of a guaranty stock association. *Id.* (citing *In re Pacific Coast Bldg.-Loan Ass'n*, 15 Cal. 2d 134, 99 P.2d 251, 254 (1940)).

52. 514 F.2d at 1207-08. The court stated that § 591 of the Internal Revenue Code permits the association to deduct amounts paid on deposits or withdrawable accounts. An association, however, may not deduct dividends paid on guaranty stock. *Id.* For a discussion of I.R.C. § 591, see *infra* note 71. The court further discussed § 593(b)(1)(B), which provides that "deposits and withdrawable accounts" are treated alike in computing one of the limitations placed upon additions to the bad debt reserve. 514 F.2d at 1208.

53. 514 F.2d at 1208 (citing E. PRATHER, SAVINGS ACCOUNT 296-97 (4th ed. 1970); R. RUSSELL, SAVINGS AND LOAN ASSOCIATIONS 132 (2d ed. 1960)).

54. 514 F.2d at 1206.

55. 223 F. Supp. 134 (S.D. Cal. 1963); see *supra* text accompanying note 29.

56. 448 F.2d 357 (10th Cir. 1971); see *supra* text accompanying note 35.

57. 514 F.2d at 1208 n.16.

58. *Id.* at 1208. The court recognized that in some cases mutual shareholders possess substantial proprietary rights. In such cases, the debt and equity characteristics of mutual shares and guaranty stock merge and become inseparable. The shareholders in *Home II*, however, did not possess such substantial proprietary rights. *Id.* at 1208-09.

59. *Id.* at 1208-09. Mutual shares constitute the only equity interests involved in the merger of two mutual savings and loans, whereas in *Home II* the equity interest consisted of guaranty stock in addition to mutual shares.

60. 607 F.2d 970 (Ct. Cl. 1979).

on facts similar to those in *Everett* and *West Side*.⁶¹ Analogous to the share account holders in those cases, Capital Savings account holders possessed the right to vote, the right to elect the association's board of directors, and the power to amend the association's bylaws and articles of incorporation. The shareholders could also participate in the liquidation proceeds of the association, but only after the association had satisfied the claims of its creditors.

The government urged the court to classify a savings and loan account as the equivalent of cash, the receipt of which violates the continuity of interest test. The court rejected the government's argument, noting that the share accounts have characteristics of both debt and equity.⁶² The court held that the merger of a savings and loan association with outstanding guaranty stock into a mutual savings and loan association without stock satisfied the continuity of interest test because the debt characteristics of the shares did not outweigh their equity features.⁶³ In reaching the conclusion that the shares constituted stock or securities as required by the nonrecognition provisions of the Code, the court emphasized that the Capital savings accounts comprised the only interests with proprietary and equity rights available to the stockholders of the acquired association in exchange for their stock.⁶⁴

As seen from the foregoing discussion of the savings and loan association cases, the majority of lower courts have consistently held that mutual shares constitute proprietary interests that satisfy the continuity of interest doctrine. Recently, however, the Ninth Circuit categorized withdrawable shares and investment certificates of deposit as debt and not equity. The Supreme Court did not address the issue of classifying mutual shares for the purposes of the nonrecognition provisions of section 354(a) of the Code until *Paulsen v. Commissioner*.

III. *PAULSEN V. COMMISSIONER*

In *Paulsen* the Supreme Court resolved the conflict between the circuits on the issue of whether passbook savings accounts and time certificates of deposit of mutual savings and loan associations constitute equity interests for the purpose of satisfying the continuity of interest doctrine. The majority opinion, written by Justice Rehnquist, recognized the hybrid nature of

61. In an acquisition similar to the mergers in *Everett* and *West Side*, stockholders of Franklin Savings & Loan Association exchanged their stock for mutual shares in Capital Savings & Loan Association. The transaction qualified as a reorganization within the literal language of § 368 of the Code; however, the acquisition would not qualify as a tax-free reorganization unless the mutual shares of Capital constituted equity interests. *Id.* at 974.

62. *Id.* at 974.

63. *Id.* at 975.

64. *Id.* at 976-77. The court stated: "[A]s the law assumes that someone must own an association or corporation, we join the courts in *West Side, supra* and *Everett, supra*, in refusing to reach a decision which illogically implies that Capital is an association without owners and which may unduly hinder otherwise desirable reorganizations." *Id.* at 976 (footnote omitted).

mutual shares, which have both debt and equity characteristics.⁶⁵ The majority concluded, however, that the debt characteristics of the mutual shares greatly outweighed the equity attributes.⁶⁶

The Court observed that the equity in a mutual savings and loan association diffuses throughout all of the depositors, compared to equity in a stock association, which concentrates in the stockholders.⁶⁷ The ownership interest of each shareholder in relation to the total value of the shares, therefore, is much smaller in a mutual association than in a stock association.⁶⁸ The majority found the voting rights of shareholders to be insignificant because shareholders could acquire only a limited number of votes and each loan diluted the votes of the shareholders.⁶⁹

The Court then compared the payment of dividends on net earnings of the association to payment of interest on savings accounts. The majority agreed with the appellate court's conclusion that the payment of dividends at a fixed, preannounced rate rendered the dividend payments nothing more than interest payments.⁷⁰ In support of this conclusion the majority noted that the Code treats these dividends as deductible like interest on bank accounts rather than as a nondeductible return of capital like dividends of a stock corporation.⁷¹ Finally, the Court determined that the right to participate in the net proceeds of a solvent liquidation did not constitute a significant part of the value of the shares.⁷² Because the Court considered the possibility of a solvent liquidation of a mutual savings and loan association to be a very speculative event, the Court found that the liquidation rights had little or no

65. 105 S. Ct. 627, 631, 83 L. Ed. 2d 540, 546 (1985). For cases discussing the hybrid nature of mutual shares, see *supra* note 26.

66. 105 S. Ct. at 633, 83 L. Ed. 2d at 549. The majority found that the equity attributes associated with the shares contributed an insubstantial value to the shares when compared to the debt attributes of such shares. For a discussion of the valuation of equity and debt attributes of mutual shares, see text accompanying *infra* notes 72-77. Justice O'Connor noted in the dissent that the only support for the Court's separate valuation is Rev. Rul. 265, 1969-1 C.B. 109, which no other court had previously followed. 105 S. Ct. at 638, 83 L. Ed. 2d at 555. For a discussion advocating abolition of the all-or-nothing characterization, see Comment, *supra* note 6, at 194-201.

67. 105 S. Ct. at 631, 83 L. Ed. 2d at 546-47.

68. *Id.*

69. *Id.*, 83 L. Ed. 2d at 547. Holders of savings accounts received one vote per \$100 on deposit; however, no shareholder could receive more than 400 votes. *Id.* The voting power of a shareholder was diluted every time a loan was made because each borrower received one vote. *Id.* The addition of a depositor also diluted the voting power of any shareholder who possessed the maximum number of votes.

70. *Id.* The Court of Appeals for the Ninth Circuit held that the dividend distributions were essentially equivalent to the interest paid by stock savings and loan associations. *Paulsen v. Commissioner*, 716 F.2d 563, 567 (9th Cir. 1983). The court of appeals noted that depositors act based on the rate of return on their investment and the security of their deposits. *Id.* at 568.

71. 105 S. Ct. at 631-32, 83 L. Ed. 2d at 549. I.R.C. § 591(a) (1982) provides:

In the case of mutual savings banks . . . and other savings institutions chartered . . . under Federal or State law, there shall be allowed as deductions in computing taxable income amounts paid to, or credited to the accounts of, depositors or holders of accounts as dividends or interest on their deposits or withdrawable accounts

Id.; see *supra* note 52.

72. 105 S. Ct. at 632, 83 L. Ed. 2d at 547.

value.⁷³

After reaching its decision that the equity features of the shares were insubstantial, the Court discussed the predominant debt characteristics of the mutual shares.⁷⁴ The majority observed first that the passbook accounts and time certificates of deposit were not subordinate to the claims of the creditors of the association.⁷⁵ The nonsubordination of the shares supported the government's contention that the share account holders constituted creditors rather than equity owners of the association. Furthermore, the shareholders could withdraw their deposits by giving thirty days' notice to the association. Although the depositors could not withdraw their funds for one year following the merger, the Court found this restriction to be more like a delay in payment than a determinative alteration in the character of the instruments.⁷⁶ Reasoning that the debt value of the shares equalled the face value because no one would pay more for the shares than their face value, the Court concluded that the equity features added practically no incremental value to the shares.⁷⁷

At the conclusion of its analysis, the majority reviewed prior case law.⁷⁸ In *Helvering v. Minnesota Tea Co.* the Supreme Court had stated that for an exchange to qualify for nonrecognition treatment, the interest retained in the surviving corporation "must be definite and material; it must represent a substantial part of the value of the thing transferred."⁷⁹ The majority determined that the Paulsens' exchange failed to satisfy the continuity of interest requirement because the retained equity interest in the mutual savings and loan association was unquantifiably small and, therefore, did not form a substantial part of the value of the surrendered stock.⁸⁰

The Court next attempted to reconcile its holding with Revenue Ruling 69-3.⁸¹ In the ruling the Commissioner stated that a merger of a mutual association into another mutual association or a stock association would qualify as a tax-free reorganization.⁸² The Court explained that when two mutual associations merge, the exchange meets the *Minnesota Tea Co.* test of materiality because the proprietary interest represented by the shares received, even though small, equals the proprietary interest represented by the shares exchanged.⁸³ According to the majority, when a mutual association merges with a stock association, the shareholders increase their proprietary

73. *Id.*

74. *Id.*, 83 L. Ed. 2d at 547-48.

75. *Id.*, 83 L. Ed. 2d at 548.

76. *Id.*

77. *Id.*

78. *Id.*, 83 L. Ed. 2d at 549. The court noted that the mutual shares did not differ significantly from short-term notes, which the Court had found to be cash equivalents. *Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462, 468-69 (1933). See *supra* note 22-23 and accompanying text.

79. 296 U.S. 378, 385 (1935); see *supra* note 19.

80. 105 S. Ct. at 632, 83 L. Ed. 2d at 548.

81. Rev. Rul. 69-3, 69-1 C.B. 103. For discussion of the ruling, see *supra* note 43.

82. *Id.*

83. 105 S. Ct. at 633, 83 L. Ed. 2d at 549.

interest by exchanging mutual shares for stock.⁸⁴ In *Paulsen*, however, the shareholders' equity interest diminished because the proprietary interest represented by the mutual shares was insubstantial when compared to the proprietary interest of the guaranty stock.

The majority concluded by stating that its holding did not conflict with an earlier decision⁸⁵ that withdrawable mutual association shares constituted securities as defined in section 3(a)(10) of the Securities and Exchange Act of 1934.⁸⁶ Noting that the purpose of the Securities Act differed from that of the Tax Code, the Court found that a liberal construction of the definition of security in the Securities Act was warranted, but declined to construe the scope of the reorganization provisions in a similar manner.⁸⁷

Justice O'Connor, in a dissenting opinion joined by Chief Justice Burger, stated that the majority's holding conflicted with the decisions of all courts that had considered similar transactions and thus introduced uncertainty into the area of tax law.⁸⁸ Justice O'Connor further argued that the mutual share account holders retained all of the relevant rights of corporate stockholders.⁸⁹ She noted that share account holders possess all of the equity in a mutual association to the extent that any equity exists.⁹⁰ Justice O'Connor also disagreed with the majority's separate valuation of the debt and equity characteristics of the same instrument.⁹¹ Again she noted the lack of judicial precedent for the majority's action. Finally, Justice O'Connor criticized the majority's reasoning that a merger between mutual associations qualifies as tax-free, but a merger of a stock association into a mutual association does not satisfy the definite and material test of *Minnesota Tea Co.*⁹² Justice O'Connor insisted that the equity interest represented by the mutual share accounts constituted the sole ownership interest in the association and that the holders of these accounts received them in exchange for an equivalent sole ownership interest in the stock savings and loan association. Thus, the equity interest that the shareholders received equalled the equity interest that they surrendered.⁹³

Justice O'Connor concluded the dissenting opinion by stating that the majority's holding would discourage mergers entered into for valid business

84. *Id.* But see *Roebing v. Commissioner*, 143 F.2d 810, 813-14 (3d Cir.), cert. denied, 323 U.S. 773 (1944). In *Roebing* the court rejected the taxpayer's argument that the court should determine whether the continuity of interest requirement was met by comparing the taxpayer's rights before and after the merger. The taxpayer in that case argued that although he had no equity interest before the merger, the exchange satisfied the continuity of interest doctrine because he received a similar interest in the acquiring corporation. *Id.*

85. *Tcherepnin v. Knight*, 389 U.S. 332 (1967).

86. 105 S. Ct. at 634, 83 L. Ed. 2d at 549-50; see 15 U.S.C. § 77c(a)(10) (1982).

87. *Id.*

88. *Id.* at 634, 83 L. Ed. 2d at 550.

89. *Id.* at 636, 83 L. Ed. 2d at 552. The shareholders had the right to vote, the right to share in net assets on liquidation, and the right to share in profits of the association. *Id.*

90. *Id.*; see *supra* note 64 and accompanying text.

91. 105 S. Ct. at 636, 83 L. Ed. 2d at 552-53.

92. See *supra* note 19.

93. 105 S. Ct. at 636, 83 L. Ed. 2d at 553.

purposes without regard to the economic benefits of such mergers.⁹⁴ She advocated a test that would treat a hybrid instrument that has the principal attributes of equity ownership as equity for the purposes of the continuity of interest requirement.⁹⁵ For these reasons Justice O'Connor would have reversed the appellate court decision.

IV. CONCLUSION

In *Paulsen v. Commissioner* the Supreme Court held that the merger of a stock savings and loan association into a mutual savings and loan association does not qualify as a tax-free reorganization under section 368(a)(1)(A) of the Code. The Court found that the plan of merger did not satisfy the continuity of interest requirement because the debt characteristics of the mutual shares that the stockholders in the acquired association received greatly outweighed the equity attributes. The dissent contended that courts should not value the debt and equity features of such shares separately, but should treat the shares as equity if they retain the principal characteristics of equity ownership. *Paulsen* gave the Court its first opportunity to consider the use of hybrid instruments in reorganizations. The Court seems to leave open the possibility that a merger of a stock savings and loan association into a mutual savings and loan association can qualify as a tax-free reorganization. By separately valuing the debt and equity attributes of mutual shares, the majority indicates that a merger qualifies as tax-free when the value of the equity characteristics outweighs the value of the debt characteristics. The Court, however, determined that the debt value of mutual shares equals the face value of such shares, thereby eliminating the possibility that the value of the equity attributes will ever exceed the value of the debt attributes. As a result, the Court has in effect halted the tax-free mergers of stock savings and loan associations into mutual savings and loan associations.

Susan Evans Coleman

94. *Id.* at 638, 83 L. Ed. 2d at 555.

95. *Id.*

