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Robert A. Kantor

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Section 1031 Exchange of Like Kind Property: A Court in Trouble

Taxpayers, Mr. and Mrs. Carlton, granted an option contract to General Development Corporation to acquire their ranch land. The contract provided that the Carltons could require General to purchase other ranch property for the purpose of exchanging the properties in lieu of cash payment. Throughout the negotiations Carlton intended to execute, pursuant to section 1031 of the Internal Revenue Code of 1954, a non-taxable exchange of his ranch for other property suitable for ranching. Pursuant to the option contract, Carlton arranged for General's purchase from third parties of two other properties, which Carlton would accept in the exchange. When General exercised its option to acquire Carlton’s property, it signed purchase contracts for the exchange properties. To avoid duplication in title transfer, arrangements were made whereby title to the two exchange properties would be conveyed directly to Carlton. General assigned its purchase contracts for these two properties to Carlton and gave him the total amount of their purchase price. In addition, General gave Carlton a mortgage note for the balance of the acquisition cost of the Carlton ranch. On the same day, Carlton executed a deed to General for his ranch and proceeded to consummate the purchase of one of the two exchange properties under the contract assigned to him by General. He gave his personal check to the seller and received title to that property. On the following day Carlton closed the transaction for the second property in a similar manner. The Commissioner contended, and the district court concluded, that because General had never acquired legal title to the exchange properties, it had no property to exchange. Thus, the transaction constituted a sale and repurchase which did not qualify as a like kind exchange under section 1031. Carlton, on appeal, maintained that the transaction should be viewed in its entirety, and that his intent to create an exchange of properties of like kind was accomplished as the end result. Held, affirmed: The substance of the transaction, rather than the intention of the taxpayer, determines the incidence of taxation. The substance of this transaction was that “the appellants received cash for the deed to their ranch property and not another parcel of land” and this constituted a sale of the ranch property which rendered the “non-recognition of gain provisions of § 1031 inapplicable.” Carlton v. United States, 385 F.2d 238 (5th Cir. 1967).

1 The contract also provided that if no suitable exchange property could be found, General could acquire Carlton’s ranch for a specified cash payment plus a mortgage note.
2 Int. Rev. Code of 1954, § 1031(a) provides that no gain or loss shall be recognized upon an exchange of like-kind properties held for productive use or investment.
3 This mortgage and cash are considered “boot” and are taxable to the taxpayer under § 1031(b). The tax on the “boot” is not in issue in the Carlton case nor in this Note. See Dean, Like Kind Exchanges and Involuntary Conversion of Real Estate, 18 A.B.A. Bull. Section on Taxation, Part 2, at 16 (1965).
4 Carlton v. United States, 255 F. Supp. 812 (S.D. Fla. 1966). In their tax return of 1959 the Carltons treated the transaction as an exchange under § 1031. The Internal Revenue Service considered it a sale and assessed taxpayer with a deficiency. Taxpayer paid the deficiency and filed suit in the district court for refund.
I. LEGISLATIVE AND EARLY JUDICIAL HISTORY OF SECTION 1031

Prior to 1924 there was great uncertainty as to what type of transactions would qualify as tax-free exchanges of property. In an attempt to relieve this uncertainty, Congress in that year enacted section 203(b)(1), the predecessor to section 1031. Under section 203(b)(1) non-recognition benefits were first limited to transactions involving property of like kind. However, even after the enactment of section 1031, there were no adequate standards for determining what actually constituted a non-taxable exchange. The basic problem was whether or not a transaction would qualify if the substantive net result was an exchange of like kind property even if the form of the exchange was not the actual trading of one property for another of like kind.

The converse of this problem, i.e., "the extent to which taxpayers have been free to minimize their tax obligations by choosing one legal form rather than another," has also been a major factor in many areas of tax law since the inception of the federal income tax. Although some courts have followed a 1944 decision of the Supreme Court that the substance, rather than the form, of the transaction determines the incidence of taxation, a myriad of decisions indicate that tax cases cannot be bound by a semantic question of substance and form.

As illustrated by the early cases involving multi-party exchanges under section 1031, the real issue was whether the transaction was one which the statute was designed to cover. Two factors were of primary consideration in determining whether a given transaction would qualify as a tax-free exchange under section 1031. The first was the overall effect of the transaction. While in "theory the taxpayer may have realized a gain or loss . . . in fact his economic situation was the same after as it was before the transaction." It was the purpose of the statute to postpone "taxation until

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7 Treas. Reg. § 1.1031(a)-1(b) (1966): "As used in section 1031(a), the words 'like kind' have reference to the nature or character of the property and not to its grade or quality.
9 Id.
10 Commissioner v. Court Holding Co., 324 U.S. 331 (1945).
11 E.g., Carlton v. United States, 387 F.2d 238 (5th Cir. 1967); Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); Allegheny County Auto Mart, Inc. v. Commissioner, 208 F.2d 693 (3d Cir. 1953); Coastal Terminals, Inc. v. United States, 207 F. Supp. 360 (E.D.S.C. 1962), aff'd, 320 F.2d 333 (4th Cir. 1963).
12 Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1931), acquiesced in, XIV-1 CUM. BULL. 13 (1935); see Trenton Cotton Oil Co. v. Commissioner, 147 F.2d 33 (6th Cir.), rehearing denied, 148 F.2d 208 (6th Cir. 1945); Harriss v. Commissioner, 143 F.2d 279 (2d Cir. 1944); Vallet Waste Mills v. Page, 111 F.2d 466 (5th Cir. 1940), cert. denied, 312 U.S. 681 (1941); Corn Prods. Ref. Co., 20 T.C. 395, 400 (1951).
13 Century Elec. Co. v. Commissioner, 192 F.2d 115, 119 (8th Cir. 1951), cert. denied, 324 U.S. 954 (1912), citing Fairfield S.S. Corp. v. Commissioner, 137 F.2d 321 (2d Cir. 1943). This is in accord with a House Ways and Means Committee report that § 203(b)(1) of the Revenue Act of 1924 would apply where the taxpayer's money is still tied up in the same type of property. H.R. Rept. No. 704, 73d Cong., 2d Sess. 13 (1939). See also Jordan Marsh Co. v. Commissioner, 269 F.2d 473 (2d Cir. 1959).
there had been a substantial change in the form of investment." The second factor was the form of the transaction. As emphasized in the House debate on the 1924 Revenue Act, where a distinction was made between an "exchange" and a "sale and repurchase," unless there was a reciprocal transfer of like kind properties the non-recognition benefits would not accrue.

Soon after the enactment of section 1031, the Tax Court, in *Mercantile Trust Co. v. Commissioner,* recognized that where there was an actual exchange of properties and the total effect of that exchange did not change the taxpayer's "form of investment," the transaction was entitled to tax-free treatment under section 1031. In that case the Commissioner contended that the party "exchanging" property with the taxpayer was actually the agent of the taxpayer. The implication was that if he were an agent the transaction could be viewed as if the taxpayer himself had purchased the exchange property and no exchange would result. However, the court concluded that what had "actually occurred" was an exchange within the meaning of section 1031.

Exchange transactions under section 1031 are complicated by the fact that very few natural situations for reciprocal exchanges of like kind property exist. As a result, these exchanges frequently have to be fabricated. Following the *Mercantile* rationale, that the substantive total effect of the transaction will control, courts have been lenient in allowing both parties to "engineer" an exchange. For example, one party to the exchange may acquire his property solely for the purpose of the exchange. In addition, the taxpayer may be active in finding and arranging for the purchase of the new properties for the exchange. "[A]s long as these activities cannot be construed to have resulted in the purchase of the exchange properties by the taxpayer, a subsequent exchange will qualify under section 1031.

The "fabrication" of these transactions implied that the taxpayer was motivated by a desire to avoid taxation. But this desire did not affect section 1031 transactions because it was well established, by the Supreme

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15 Revenue Act of 1924, ch. 116, § 202, 43 Stat. 226. Mr. LaGuardia: "Under this paragraph is it necessary to exchange property? Suppose the property is sold and other property immediately acquired for the same business. Would that be a gain or loss, assuming there is greater value in the property acquired?" . . . Mr. Green: "If the property is reduced to cash and there is a gain, of course it will be taxed." Mr. LaGuardia: "Suppose that cash is immediately put back into the property, into the business?" Mr. Green: "That would not make any difference." 65 CONG. REC. 2799 (1924).
16 Id. at 82.
19 See, e.g., Wineberg v. Commissioner, 326 F.2d 157 (9th Cir. 1963); W.D. Haden Co. v. Commissioner, 165 F.2d 388 (5th Cir. 1948); Coastal Terminals, Inc. v. United States, 207 F. Supp. 560 (D.D.C. 1962), aff'd, 320 F.2d 333 (4th Cir. 1963).
20 Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1965) (allowing taxpayer to select the exchange property, make the purchase arrangements, pay a portion of the purchase price and make improvements on the exchange property prior to title transfer). See also Coastal Terminals, Inc. v. Commissioner, 320 F.2d 333 (4th Cir. 1963).
21 Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963).
Court's affirmance of Judge Learned Hand's ruling in Helvering v. Gregory, 22 that a transaction "does not lose its immunity because it is actuated by a desire to avoid . . . taxation."23 However, in Gregory the court went on to discuss transactions designed solely to evade taxation. It determined that even though a transaction conformed to a "dictionary definition" of the terms of a statute it did not necessarily "follow that Congress meant to cover such a transaction . . . ."24

Following this reasoning, courts have placed great emphasis on a determination of the type of transaction which Congress meant to be an "exchange" under section 1031.25 In contradistinction to the House debate26 some courts held that the "form" of a "sale and repurchase" did not always disqualify the transaction from the tax-free benefits of section 1031,27 especially where "a sale is part of a transaction the purpose of which was to effectuate an exchange."28 As long as the result of the transaction was that the taxpayer's investment remained in like kind property, the sale might be disregarded.29 However, these cases involved unique factual situations,30 and no rule was established that all sales and repurchases would be exchanges, even if the total effect of the transaction was an exchange within the meaning of the statute.31

A different variation from the form of a "reciprocal transfer of properties" was upheld as a section 1031 exchange in W. D. Haden Co. v. Commissioner.32 In that case, taxpayer A agreed with agent B to exchange taxpayer's property for a property owned by C. B then arranged with C for the acquisition of C's property. B further contracted with D, a fourth party, for D's purchase of taxpayer's property. To close the transaction, taxpayer A, at the request of B, transferred his property to D. C, at the request of B, transferred his property to taxpayer A. The Fifth Circuit held that the substance of the transaction was an exchange which would qualify for the non-recognition benefit of section 1031, despite the fact that no reciprocal transfer of properties occurred. This rule, that substance controls over form in section 1031 transactions, reaffirmed the theory expressed by the Tax Court in Mercantile.33 Where the true intent of the taxpayer is to effect an exchange and "the net effect is that the taxpayer ends up with property of the same character . . . the means of effecting that

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22 293 U.S. 465 (1935); for a discussion of Gregory's effect on tax law, see Chirelstein, supra note 8.
23 69 F.2d 809, 810, 811 (2d Cir. 1934).
24 Id.
25 See note 1 supra.
26 Cases cited note 19 supra.
27 Id.; see note 15 supra.
28 Cases cited note 13 supra.
29 See 3 J. MERTENS, FEDERAL INCOME TAXATION § 20.28, at 96 n. 63.1 (1965).
31 E.g., in Frederick R. Horn, 3 T.C. 250 (1945), the court denied taxpayer's loss in finding that an alleged sale and repurchase of a membership on the coffee and sugar exchange was, in substance, an exchange under § 1031. Under Rev. Rul. 57-469, 1957-2 CUM. BULL. 521 the Commissioner found that a sale and subsequent repurchase of like kind properties was an exchange where state law prohibited an exchange. See also note 23 supra.
32 See cases cited note 12 supra.
33 165 F.2d 588 (5th Cir. 1948).
34 32 B.T.A. 82 (1935); see notes 16, 17 supra, and accompanying text. See also Rev. Rul. 57-244, 1957-1 CUM. BULL. 247.
exchange should be immaterial.\textsuperscript{25}

While the intent of the taxpayer in \textit{Haden} was to exchange his property, the court did not affirmatively state that his intent was determinative of the substance which controlled the tax treatment. But the importance of the taxpayer's intent as an integral part of the substance of the transaction was established in \textit{Century Electric Co. v. Commissioner}.\textsuperscript{26} In that decision, the Eighth Circuit said that the "tax consequences must depend on what was actually intended and accomplished rather than on the separate steps taken to reach the desired end."\textsuperscript{27} The distinction between the taxpayer's intent and his motivation is subtle, but important. According to \textit{Century Electric}, the motive of the taxpayer to manipulate his transaction into or out of the auspices of section 1031 will not, of itself, change a sale into an exchange. However, the taxpayer's intent to maintain his holding of like kind property may be viewed, with the net result of the transaction, to determine whether an exchange has occurred within the meaning of section 1031.

In \textit{Haden} and \textit{Century Electric} the courts espoused a liberal interpretation of the language of section 1031. Consistent with those decisions was the finding in a later case, \textit{Jordan Marsh Co. v. Commissioner},\textsuperscript{28} that through section 1031 Congress meant to remove "the inequity . . . of forcing a taxpayer to recognize a paper gain which was still tied up in a continuing investment of the same sort."\textsuperscript{29} Another case implied that even where cash was received, the taxpayer could still claim an exchange by establishing that the sale was merely an integral part of a single transaction designed to effectuate an exchange.\textsuperscript{30} However, more in line with the House debate\textsuperscript{41} position, later cases have emphatically stated that a transaction must have the form of an actual exchange in order to qualify under section 1031.\textsuperscript{42}

\section*{II. Alderson and Carlton: A Semantic Problem of Substance over Form}

Under the guise of the holding in \textit{Haden}\textsuperscript{43} that substance controls over form in section 1031 transactions, the two most recent cases, \textit{Alderson v. Commissioner}\textsuperscript{44} and \textit{Carlton v. United States},\textsuperscript{45} paid lip service to control-
ling substance, but actually considered nothing but form to determine the incidence of taxation. In *Alderson* a cash sale contract had been executed by the taxpayer and the purchaser of his property. The buyer deposited approximately ten per cent of the purchase price in an escrow account. Prior to the time when all conditions precedent to the transfer of title were met, the parties amended the contract to provide that the buyer would acquire other property, which the taxpayer might choose, for the purpose of exchanging it for the taxpayer's property. If no suitable property could be found within three weeks, the cash transaction would be consummated as originally planned. A new property was located and the exchange took place. The Ninth Circuit concluded that the amendment to the contract had recast the form of the transaction from an outright sale to a potential exchange for tax purposes.  

At the time of the original contract in *Alderson*, the parties clearly intended a sale. However, at the time of consummation, they intended to utilize the delayed recognition provisions of section 1031 specifically to avoid taxation. Thus, the taxpayer's subjective intent to sell his property was "related to the legal relationship ensuing from the form of the agreement" and modified by what was actually done. Since the parties actually exchanged deeds, which is the form of an exchange, the court concluded that the substance of the transaction was an exchange.  

*Alderson* is distinguished from *Carlton* by the fact that in *Carlton* the taxpayer always intended to exchange his ranch property for other property suitable for ranching. The court in *Carlton* disregarded the intent of the taxpayer by holding that the substance of the deal was determined only by "what was actually done." While insisting that the substance of the transaction, and not the form, controls, the Fifth Circuit virtually established the converse of this as law. They did so by labeling form as substance. For them, the substance of the transaction was "that appellants received cash for the deed to their ranch property, not another parcel of land."  

Essentially the court was confined to a determination of whether an exchange could exist if the mark of a sale, i.e., the receipt of cash, was present. The finding of the court, that it could not, overlooked a multitude of precedents as well as several rulings by the Internal Revenue Service that if the total effect of the transaction is an exchange, it may qualify under section 1031. The Fifth Circuit considered some of these cases as "factually distinguishable or inapposite" because the subject matter of these cases...
was an exchange of corporate stock, which had been specifically excluded from the scope of section 1031. However, the cases still presented the basic theory of law. The concepts were, indeed, the same.

Alderson and Carlton point out that the real issues underlying multi-party exchanges of like kind property cannot be reduced to the semantic question of “substance and form.” It is imperative that the court not allow “the true nature of a transaction to be disguised by mere formal issues which exist solely to alter tax liabilities.” Because the form of the transaction actually controlled in these cases, a cash sale in Alderson was transformed into an exchange, and an exchange in Carlton became a sale.

“Section 1031 is not an elective provision, but applies automatically to transactions which meet its requirements.” Just what these requirements are is not clearly defined in the statute. According to Carlton, the requirements are essentially matters of form. The Commissioner conceded that the Carlton transaction would have qualified under section 1031 if the proper form had been followed. If General had taken title to the exchange properties and transferred them to Carlton, an exchange would have occurred.

The court in Carlton placed a limit on what the taxpayer may do in engineering his exchange: he cannot receive cash from the purchaser of his property even if he immediately pays the money to a third party to secure title to the exchange property. Yet he may, as in Haden, receive title directly from the third party. Several authorities have concluded that the taxpayer’s freedom in fabricating the exchange is paramount to allowing him to sell his property and reinvest the proceeds.

III. Conclusion

In evaluating the current status of section 1031 as accomplishing the intention of the legislature, the theory behind similar non-recognition provisions should be considered. Section 1033 (a) (2) of the 1954 Code provides that no gain shall be recognized if money received in the involuntary conversion of property is “expended in the acquisition of other property similar or related in service or use.” The purpose of this statute is to enable the taxpayer to re-establish a status quo through investment of insurance proceeds where his property has been taken or destroyed. If the tax-

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83 For the list of exclusions, see INT. REV. CODE of 1954, § 1031 (a).
84 J. MERTENS, FEDERAL INCOME TAXATION § 20.26 (1965).
85 Commissioner v. Court Holding Co., 324 U.S. 331, 333 (1945). See also Schultz v. Commissioner, 294 F.2d 52, 56 (9th Cir. 1961).
86 West & Chodorow, note 22 supra, at 56.
87 Brief for Appellee at 25, Carlton v. United States, 385 F.2d 238 (5th Cir. 1967), citing as authority: Coastal Terminals, Inc. v. United States, 320 F.2d 333 (4th Cir. 1963); Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963); W. D. Haden Co. v. Commissioner, 163 F.2d 388, 390 (5th Cir. 1948); J. H. Baird Publishing Co., 39 T.C. 608 (1962); Mercantile Trust Co. v. Commissioner, 32 B.T.A. 82 (1935); Antoine Borchard, F-H TAX CT. REP. & MEM. DEC. 65,297 (1965).
88 Dean, note 3 supra; Schaner, note 1 supra; Spears & Freedman, note 35 supra; West & Chodorow, note 22 supra; I.R.C. § 1031 Held Not Applicable When Precise Form Not Followed, 41 FLA. B.J. 1262 (1967).
89 INT. REV. CODE of 1954, § 1033.
90 Id.
payer keeps the money and does not so reinvest, there will be a taxable event causing a recognition of any gain or loss which the taxpayer realized from the proceeds. An early form requirement that the taxpayer trace the funds to the new investment was found to work undue hardship and was repealed.

Similar flexibility is found in section 1034, which provides for non-recognition of gain upon the sale or exchange of a residence. This provision allows reinvestment in another home within a one-year period, applying the tax basis of the old home to the new.

Like section 1031, neither section 1033 nor section 1034 are optional with the taxpayer. Although their requirements differ, the philosophy behind all three appears to be the same. Each is concerned with delaying the tax consequences of an otherwise taxable event to the extent that the taxpayer is in the same economic position after the transaction as he was before it. In addition, section 1031 was enacted to remove any tax inhibitions the taxpayer might have in upgrading his holdings “for productive use or investment.” Under section 1031, although the taxpayer receives more for his property than he paid for it, he puts his gain back into like kind property and, therefore, retains no cash flow. To the extent that he does retain cash or unlike property proceeds, he will be taxed.

Section 1031’s application continues to expand as new types of investments occur. There has been wide and extensive use of its benefits by persons investing in real estate. Investment real estate is covered by section 1031, as is property held for a continuing business. However, when transactions under the section involve a rancher’s acquiring a new ranch, the net result will fairly reflect his intent to retain an investment in like kind property, regardless of the form of the transaction. The same is not true of investment in real estate where the intent may be to sell one’s property and hold the money for investments in other fields. The investor may utilize an “exchange or purchase” contract, which has been construed to come within the meaning of section 1031, to consummate a sale of his property and still gain the non-recognition deferral benefit if he chooses to reinvest in property of like kind. The businessman, on the other hand, whose exchange of like kind business property is precisely within the purpose of the statute, may lose the tax-free treatment if his transaction does not exactly follow a rigid form. To hold arbitrarily that the form of the transaction must be a direct exchange of property, while ignoring the substantive total effect and the objective intent of the taxpayer, seems inequitable.

A possible remedy for this inequity would be to “amend § 1031 to provide for tax-free treatment where the taxpayer makes a sale followed by

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63 Dean, supra note 3.
64 Alderson v. Commissioner, 317 F.2d 790 (9th Cir. 1963).
65 Often this “deferral effect may ripen into a total exemption upon death” because under Int. Rev. Code of 1954, § 1014, a decedent receives the property with a new basis equal to the fair market value at the time of the inheritance. See Dean, note 3 supra.
66 The court in Carlton qualified its decision on the basis that there “is no equity in tax law.” 385 F.2d at 243.
a reinvestment of the sale proceeds in like kind property within a stated
time. An alternative remedy may be applied in the courts. The courts
have determined that the substance of the transactions will determine the
incidence of taxation. If they would now establish that the substance of
a transaction is the net result coupled with the intention of the parties,
they could still uphold purchase-option contracts while terminating the
type of inequity which occurred in Carlton. Either remedy would insure
that a different tax treatment would not follow when two businessmen in
the same business wish to expand or relocate their businesses, but business-
mans A is able to effectuate a direct exchange while businessman B can not,
or inadvertently does not, acquire the property he needs in a direct ex-
change. Until one of the above proposed remedies is effectuated, persons
attempting to create like kind exchanges should be extremely careful. If
the result in Carlton is followed, the formal exchanges of deeds or titles
must occur, irrespective of the total effect of the transaction.

Robert A. Kantor

The Ten Per Cent Owner of Convertible Debentures and
Section 16(b): A Redefinition

Chemical Fund, Inc., an open-end investment company, desired to de-
crease its common stock holding in Xerox Corporation and increase its
convertible debenture holding in that corporation. Accordingly, it began
selling the common stock and buying the debentures convertible into com-
mon shares. By December 12, 1962, Chemical Fund owned ten per cent of
the outstanding debentures. The program was continued over the next
eleven months. At no time during this period could the debentures have
been converted into more than one-half of one per cent of the outstanding
common stock. Xerox claimed the right to the paper profits realized by
Chemical Fund during this period from the sales and purchases. Xerox as-
serted (1) that section 16(b) of the Securities Exchange Act of 1934 provides
for recovery of short-swing profits taken by an owner of more than
ten per cent of “any class of any equity security” of the corporation
through transactions in the corporation’s equity securities, and (2) that
Chemical Fund was liable under the statute because it owned more than
ten per cent of the class of convertible debentures. Chemical Fund brought

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67 Spears & Freedman, supra note 35, at 193.
68 Carlton v. United States, 385 F.2d 238 (5th Cir. 1967); Alderson v. Commissioner, 319
F.2d 790 (9th Cir. 1963); W. D. Haden Co. v. Commissioner, 165 F.2d 588 (5th Cir. 1948).
Xerox claimed that matching the highest sales of common stock with the lowest purchases
of debentures resulted in a profit of $153,972.43. This form of profit computation was used in
Smolowe v. Delendo Corp., 136 F.2d 231 (2d Cir.), cert. denied, 320 U.S. 751 (1943). The
decision in the principal case did not require the court to decide the correct profit computation.
directors without regard to their percentage of ownership as well as to the ten per cent shareholder.
For a part reading of the statute, see note 6 infra.