Estate of Jacob S. Kamborian et al., Petitioners, Appellants v. Commissioner of Internal Revenue, Respondent, Appellee

(CA-1), U. S. Court of Appeals, 1st Circuit, No. 72-1248, 469 F2d 219, 11/14/72,

ALDRICH, Senior Judge:

Four individuals, hereinafter taxpayers, owned some 76% of the stock of X corporation, and two of them, as trustees for the wife of another, held 50,000 additional shares, or slightly in excess of 13%. Taxpayers individually owned all of the stock of Y corporation. For bona fide business reasons X corporation decided to acquire the Y stock in exchange for 22,871 X shares. The exchange was perfected pursuant to a formal agreement which included, with the wife's consent, the purchase of 418 X shares by the trust. This resulted in increasing taxpayers' combined holdings in X to 77.3%; the trust's interest was reduced to just under 13%, notwithstanding its purchase. However, the combined holdings of taxpayers and the trust remained in excess of 80%, and taxpayers took the position that the transaction was, accordingly, to be viewed as a tax-free exchange. 1954 Int. Rev. Code, §§ 351, 368(c). The Commissioner disagreed, claiming that the "control" group, or the transaction, see post, was to be limited to taxpayers as the former owners of the Y stock. In refusing to include the trust's purchase the Commissioner relied, in part, upon Regulation 1.351-1(a)(1)(ii).

[*80% Control Test*]

The Tax Court ruled in favor of the Commissioner, [CCH Dec. 30,895] 56 T. C. No. 66 (1971), and taxpayers seek review. Basically, they make a frontal attack on the regulation, urging us to hold it invalid as going beyond

what they claim is a plain and positive statute
We start with the general proposition expressed in section 1002 of the Code,

"Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss, determined under section 1001, shall be recognized."

"TRANSFER TO CORPORATION CONTROLLED BY TRANSFEROR. BY TRANSFEROR.

[Section 351]

"Control" is defined in section 368(c) as the possession of 80% of the stock of the transferee corporation.

Taxpayers' brief contains a wistful aside that there is involved a large tax and only a small discrepancy. We are not moved, legally or emotionally, by this fact. But in order to avoid any overfall therefrom, we will imagine another case that would have to be decided against the government if taxpayers are correct and all arranged transactions, regardless of their purpose or their connection with one another, are to be viewed as a single exchange. Let us suppose that P owns 10% and S 90% of the stock of W, and P owns all of the stock of Z. If P transfers his Z stock to W for further W shares, ending up with a 30% interest, it is obviously not a tax-free exchange. But if P induces S to buy, contemporaneously, one share of W stock for cash the present petitioners would say that P and S are to be considered jointly as exchanging property, and since together they owned over 80% of the transferee corporation, P may claim the statutory exception.

Our analysis does not lead to such a result. By the term "property [that] is transferred," the statute contemplates a single transaction, even though, as it goes on to recognize, there may be a number of transferors or participants. What is a transaction must be determined in the light of the statutory purpose, lest taxpayers be allowed to frustrate that purpose by manipulation of clearly taxable exchanges. We stated that purpose long ago in speaking of the predecessor of section 351, which contains no presently material variance.

"It is the purpose of Section 112(b)(5) to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture."

Portland Oil Co. v. Commissioner, 1 Cir., 1940, [40-1 USTC ¶9234] 109 F. 2d 479, 488, *cert. denied* 310 U. S. 650.

Thus in our hypothetical, considering P alone, there was not a "mere change in the form of ownership." Before the transaction P "owned" Z corporation, since he owned 100% of its stock. After the transaction his ownership of Z was reduced to 30% because he held only a 30% interest in W, the transferee corporation. In keeping with "economic sense" a taxpayer may be allowed a certain amount of slack. This has been ruled to be 20%; and had P ended with an 80% interest in W, and thus of Z, his ownership of the latter would not be throught to be materially changed. 1954 Int. Rev. Code §368(c). But where P does not own that 80% it can be permissible to consider transfers by other owners only if those transfers were, in economic terms, sufficiently related to P's to make all of the transfers parts of a single transaction.

It is possible that a valid association may exist even when different types of property are transferred to the transferee corporation by different transferors. Thus in *Halliburton v. Commissioner,* 9 Cir., 1935, [35-2 USTC ¶9431] 78 F. 2d 265, funds contributed by other parties were found to be as necessary to the overall purpose of the transaction as was the exchange by the litigating taxpayers. In our P and S case, however, there is no economic connection, and hence no basis for regarding the two transfers as parts of one transaction, and hence of considering P and S as a unit in terms of control. If a taxpayer were able, so simply, to effect a concatenation and say that the statute applied to him, the statute would be meaningless.

The instant case presents no better claim of a connection in an economic sense. The four shareholders of Y decided it would be advantageous to merge Y with X. Finding themselves short of the requirements for tax-free treatment, they persuaded a shareholder of X, who was a complete stranger to Y, to make a token purchase of X shares. Other than the fact that the trust's participation was incorporated into the acquisition agreement, there was no relation between the exchange of Y shares and this very minor purchase. The trust transferred no Y shares. The cash it contributed to X--$5,000 for 418 shares of a corporation with nearly 400,000 shares outstanding--could have had no significant impact on X's ability to conduct its business. The trustees' desire to help the Y stockholders avoid taxes, warrantably found by the Tax Court to have been the primary motive for the trust's purchase, cannot be used to make a single transaction out of otherwise unrelated transfers.

Without going into every ramification of the Regulation, in this case it appropriately and fairly fits our interpretation of the statute. Taxpayers' criticisms of the Tax Court's opinion in this regard are not readily persuasive. However, if, in some fashion, taxpayers could remove the Regulation from consideration or application altogether, it would avail them nothing.

Affirmed.