Background Facts

411 U.S. 315 Petitioner, an individual taxpayer, for the taxable year 1968, filed a Federal income tax return for the calendar year 1968 with the Collector of Internal Revenue for the First District of New Jersey. As of the December 3, 1935, effectuation of the reorganization of the stock of South Jersey Gas, Electric and Traction Co. (hereinafter referred to as South Jersey) This stock had been acquired by petitioner's donor prior to 1936. As of 1968 South Jersey was a corporation organized on August 31, 1900, under the laws of the State of New Jersey, for the purpose of furnishing electric light, heat and power to private use in that state. In the late 1960, South Jersey had leased all its franchises, plants and operating equipment to Public Service Corporation of New Jersey. The lease was to pay rent which beginning December 1, 1968, amounted to $400,000 per annum. In addition the lessee agreed to pay the interest charges on the lessee's bonded indebtedness, all taxes, insurance and such sums as were necessary to maintain, repair and operate the leased and owned properties, All replacements and additions became the property of South Jersey subject to the terms of the lease. ;wwThe lease further provided that if South Jersey failed to pay the basic fee a period of 30 days, after notice, South Jersey could terminate the lease, reenter and repossess the property and additions and extensions thereto, and recover from the lessee. South Jersey could enter upon the leased property for the purpose of inspecting it and determining its condition and the character of the management and whether the lessee was operating in accordance and complied with Article July, 1924, this lease was assigned by Public Service Corporation of New Jersey to Public Service Electric and Gas Company which on December 1, 1968, and thereafter. On December 1, 1968, to June 1, 1957, the net outlay received by South Jersey, the lessor company, were distributed to its stockholders at the rate of 8% per annum. Prior to the lease, South Jersey had outstanding 60,000 shares of capital stock of $100 par value, of which Public Service Electric and Gas Company, the assignee of the lessee, held 1,700 shares, and Public Service Corporation of New Jersey, the original lessee, held 1,000 shares. The remaining 42,321 shares were held by other interests. Public Service Corporation of New Jersey held substantially all the voting stock of Public Service Electric and Gas Company ;wwPublic Service Electric and Gas Company as a part of its unified electrical system hold and operated under long-term leases the properties of Atlantic City Electric Company and more than ten years Public Service and its parent, Public Service Corporation of New Jersey, had engaged in a systematic effort to acquire the fee to these properties. As of 1968 it had acquired more than two-thirds of the stock of certain of these lessor companies. A projected merger of the lessee companies into Public Service Electric Gas through the exchange of stock of the lessee companies for 4% cumulative preferred stock of Electric and Gas callable in three years was enjoined by the Chancery Court of New Jersey as unfair to the minority stockholders of these companies. Outcome v. Public Service Electric and Gas Co., 24 N.J. Eq. 320 (ch.1963). In 1957, the directors of South Jersey and of Public Service Electric and Gas Company adopted a "Plan of Reorganization" under which it was proposed that South Jersey would be merged into the latter in accordance with the statutes of New Jersey. This plan provided that the stockholders of South Jersey (other than Public Service Electric and Gas Company) would exchange, dollar for dollar, their stock in South Jersey for 8% one hundred years first mortgage bonds of Public Service Electric and Gas Company. These bonds were to be guaranteed by the mortgage of Public Service Electric and Gas Company dated August 1, 1924, and under a supplemental indenture later to be executed. It was expressly provided in the plan that the exchange would not be the same day: "The capital stock of the Public Service Electric and Gas Company * * * will not be changed by reason of this agreement." Also, the stock of Public Service Electric and Gas and Electric and Gas Company was not to participate in the exchange but was to be delivered up and cancelled ;wwThe "Agreement of Merger" was accepted by the stockholders of South Jersey and of Public Service Electric and Gas Company, and approved by the Board of Public Utilities Commissioners of the State of New Jersey and by the Federal Power R2F9E2 Commission. The "Agreement of Merger" with the certificates of the respective boards of directors of companies as to the confirmatory votes of the stockholders, and the certificates of approval of the Public Utility Commissioners of New Jersey and of the Federal Power Commission were filed with the Secretary of State of New Jersey on November 27, 1958 ;wwThe "Agreement of Merger" was consummated pursuant to its provisions. In accordance therewith the Public Service Electric and Gas Co. 946 shares of stock in South Jersey, $36,600, principal amount of 8% bonds which on November 25, 1958, had a fair market value of $34,777 ;wwThe difference between the basis and difference between the basis of the taxpayer's stock in South Jersey and the fair market value of the bonds received in exchange therefor must be recognized as taxable income. ;wwThe only nonfinancial efficiency which the Tax Court mentioned, to the ex it was based upon this item.

Analysis

(1) Whether the transaction hereafter stated between a lessor corporation and its stockholders constitutes a "statutory merger", within the meaning of Sec. 112(g) (1) (A) of the Revenue Act of 1938, 26 U.S.C.A. Int.Rev.Code, §112(g)(1)(A)]

Analysis

(2) whether the decision of "continuity of interest" doctrine in the Lefiulle v. Seofield, 308 U.S. 433, 60 S.Ct. 315, 84 L.Ed. 355, applies to a "statutory merger".

Analysis

(1) that the merger of South Jersey into Public Service Electric and Gas Co. was a "true statutory merger" under the laws of the state of New Jersey and therefore the exchange of stock for bonds was not a taxable event under Sec. 112 of the Revenue Act of 1938

Analysis

(2) that since there was a "true statutory merger" the "continuity of interest" doctrine in the LeFulle v. Seofield case is inapplicable

Rule

The admitted fact that the merger of the lessee companies into Public Service Electric and Gas Company under the New Jersey law is not dispositive of the question as to whether there was a "statutory merger" here within the meaning of Sec. 112(g) (1) (A) of the Revenue Act of 1938 that cannot alter the essential characteristics required to enable a taxpayer to obtain exception under the provisions of a Federal Revenue Act.]

Holdings

We so hold in Commissioner of Internal Revenue v. Gilmore's Estate, 372 U.S. 108, 83 S.Ct 791. Indeed that case is completely dispositive of the taxpayer's first two contentions. In Gilmore's Estate we held that "statutory merger" in that case, a "true statutory merger" under the identical laws of New Jersey involved here, (1) each "true statutory merger" is unsufficient without more to qualify as a "reorganization" under the Revenue Act, and (2) that a "continuity of interest" as enunciated in numerous decisions of the Supreme Court of the United States and the pertinent Treasury Regulations is a sine qua non of a finding to establish a true reorganization. In Gilmore's Estate we said, on page 790 ;wwTo be satisfied that whether a transaction qualifies as a "reorganization" under the Revenue Act does not turn alone upon compliance with the literal language of the statute. The judicial interpretation has determined that something more may be needed and that, indeed, under some circumstances, something less will do. Thus, it has been said that "something more' must we have concluded that there was a literal compliance. * * *ww"The reorganization provisions were enacted to free from the imposition of a tax, gains that are "merely formal or incore" whereas there is a tax realization of gain or loss in the business sense but merely the recasting of the same stockers in a different form, the tax being postponed to a future date when a more tangible gain or loss is realized. * * ***

Rule

It has been recognized that a transaction may not qualify as a "reorganization" under the internal revenue acts though the literal language of the statute is satisfied. See Paul, Studies in Federal Taxation (3d Series), p. 91 et seq.

Analysis

(3) whether under the facts a "continuity of interest" actually existed.

Analysis

The taxpayer's remaining contention that this requires "continuity of interest" is present under the peculiar facts in this case is premised on a rather novel theory. He argues that "prior to the merger, the stockholders of South Jersey had no proprietary interest in its properties in any real sense", and that as - interesting the merger "the decision of the New Jersey courts recognized that the lessee, Public Service Corporation, was mentally organized to a projected 8% bond."wwThis contention places the taxpayer in an anomalous position. Whereas the "continuity of interest" principle is predicated on the existence of a proprietary right which must be preserved in the transfer of assets of a corporation, the taxpayer at one and the same time asserts that a "continuity of interest" existed in the reorganized company, even though there was no proprietary interest in the old corporation, in the merged corporation to be carried over into the reorganized corporation.wwwEvPS14 It is unnecessary, however, to further explore the contention because it appears to be so clear that he who state may stand. First, the stockholders in South Jersey had a definite and clearly fixed proprietary interest in its property. The leasehold interest, the improvements and additions to the leased property, were to be the property of South Jersey and subject to the terms and conditions of the lease. Further, on the expiration of the lease, the property and the rents of the lease were to be returned to South Jersey. South Jersey owned the property under lease even though that lease was for a 900-year term. The lease further provided that upon default of its terms South Jersey could terminate the lease and repossess the property and improvements and additions and extensions thereto.

Rule

The Pinellas case introduced the continuity of interest theory to eliminate those transactions which had the "characteristics of mere corporate reorganization" (287 U.S. page 470, 53 S.Ct. 257) 77 L.Ed. 428) and to avoid a construction which would make evasion of taxation very easy."

Analysis

(3) that in any event a "continuity of interest" actually existed in the instant case.

Rule

That Sec. 112 has made "the continuity of interest not * * * much stricter" ;ww held in Helvering v. Southland Securities Corp., 292 U.S. 510, 54 S.Ct. 788, 78 L.Ed. 789. Said the Court, page 198 of 315 U.S., at page 530 of 62 S.Ct. ;ww"Under the statute involved in Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 62 S.Ct. 530, 86 L.Ed. 775, decided this day, there would have been a 'reorganization' here. For the creditors of the old company had acquired substantially the entire proprietary interest in the new stockholders. See Helvering v. Minnesota Tog Co., 296 U.S. 378, 56 S.Ct. 268, 80 L.Ed. 284. But clause (B) of § 112(g) (1) of the 1934 Act [26 U.S.C.A. Supra] requires a "mere change in identity, form or organization" transactions whereby one corporation acquires substantially all of the assets of another See S. Rep. No. 558, 73d Cong., 2d Sess., pertaining to the Revenue Act 1933-1938, pp. 208-209. The continuity of interest test is made much stricter. See Paul, Studies in Federal Taxation (3d Series), pp. 36-41. * * ***[1] (Emphasis supplied).

Analysis

In view of the incontrovertible facts the taxpayer's contention that the stockholders in South Jersey had no proprietary interest is without basis

Analysis

Finally, it is equally clear that when the stockholders of South Jersey exchanged their stock in that corporation for the long-term bonds of Public Service Electric and Gas Company, they surrendered their proprietary interests in South Jersey to the extension of Public Service. Thus no longer entitled to the former property of South Jersey and they had a proprietary interest in the property of Public Service. The Tax Court stated the ultimate conclusion when it stated ;ww"* * * It follows that no continuing stake in the merged enterprise was retained by South Jersey or its stockholders, and hence that the transaction constituted a sale or exchange of the proprietary interests acquired by the merged enterprise, not by the bondholders' status conferred upon the former stockholders of South Jersey, supplied by the terms of the indenture of the transaction here is close to that involved in Commissioner of Internal Revenue v. Neustadt's Trust 366 U.S. 696, 81 S.Ct. 1305, 6 L.Ed. not so. In the Neustadt's Trust case the taxpayers merely exchanged their holdings of long-term debentures bonds for an equivalent face amount of short-term debentures of the same obligor. The Court and the United States Circuit Court of Appeals for the Second Circuit ruled that the transaction was part of a "recapitalization" where no transfer of assets and no change of capital stock occurred.

Conclusion

In view of the cases cited we cannot hold that the Tax Court's determination that under Sec. 112(g) (1) (A) of the Revenue Act of 1938 the requirements of New Jersey law supersede the "continuity of interest" test as applied in LeFulle v. Seofield and the numerous other decisions

Conclusion

For the reasons stated the decision of the Tax Court of the United States is affirmed.